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Status: GRANTED

Title: Cottage Savings Association, Petitioner
v.
Commissioner of Internal Revenue

Docketed:
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Court: United States Court of Appeals
for the Sixth Circuit

Counsel for petitioner: Manes, Dennis L.

Counsel for respondent: Solicitor General

NOTE: See mail label re dockt dt. See: 89-1926,
1927, 1928

Entry	Date	Note	Proceedings and Orders
2	May 22 1990	D	Application (A89-832) to extend the time to file a petition for a writ of certiorari from June 12, 1990 to July 13, 1990, submitted to Justice Scalia.
3	May 22 1990		Application (A89-832) denied by Justice Scalia.
1	Jun 11 1990	G	Petition for writ of certiorari filed.
4	Jul 13 1990		Brief of respondent CIR in opposition filed.
5	Sep 5 1990		DISTRIBUTED. September 24, 1990
6	Oct 1 1990		Petition GRANTED. The case is set for oral argument in tandem with No. 89-1926, United States v. Centennial Savings Bank FSB. *****
7	Oct 26 1990	G	Motion of petitioner to dispense with printing the joint appendix filed.
8	Nov 5 1990		Motion of petitioner to dispense with printing the joint appendix GRANTED.
9	Nov 15 1990		Brief of petitioner Cottage Savings Association filed.
11	Nov 21 1990		Record filed.
		*	Certified copy of C. A. Proceedings received.
10	Nov 23 1990		SET FOR ARGUMENT TUESDAY, JANUARY 15, 1991. (2ND CASE)
12	Nov 28 1990		CIRCULATED.
13	Dec 4 1990		Record filed.
		*	Certified copy of original record received from Tax Court.
14	Dec 4 1990		Record filed.
		*	Certified copy of exhibits received. (Box).
15	Dec 5 1990		Record filed.
		*	Certified copy of original record and briefs received.
16	Dec 19 1990	X	Brief of respondent CIR filed.
17	Jan 3 1991	X	Reply brief of petitioner Cottage Savings Assn. filed.
18	Jan 15 1991		ARGUED.

170

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No. 89-_____

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1989

COTTAGE SAVINGS ASSOCIATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

**PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT**

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QUESTION PRESENTED FOR REVIEW

- I. Does Section 165 of the Internal Revenue Code, which limits the deduction of losses to those actually sustained, prevent the deduction by a savings institution of a realized and recognized loss on an exchange of different mortgage loan portfolios, where a regulation of the Federal Home Loan Bank Board permits the taxpayer to avoid recording the loss on its books for regulatory accounting purposes?

TABLE OF CONTENTS

QUESTION PRESENTED FOR REVIEW	I
TABLE OF AUTHORITIES	v
OPINIONS BELOW	1
JURISDICTION	1
CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED	2
STATEMENT OF THE CASE	5
ARGUMENT	9
I. REASONS FOR ALLOWANCE OF THE WRIT OF CERTIORARI	9
II. QUESTION PRESENTED FOR REVIEW	11
<p>Does Section 165 of the Internal Revenue Code, which limits the deduction of losses to those actually sustained, prevent the deduction by a savings institution of a realized and recognized loss on an exchange of different mortgage loan portfolios, where a regulation of the Federal Home Loan Bank Board permits the taxpayer to avoid recording the loss on its books for regulatory accounting purposes?</p>	
A. ALL REALIZED LOSSES FROM SALES OR EXCHANGES OF PROPERTY ARE "SUSTAINED" UNDER SECTION 165	11
B. THE SIXTH CIRCUIT'S TEST FOR WHEN A LOSS IS SUSTAINED IS CON- TRARY TO PRECEDENT.	12
C. THE SIXTH CIRCUIT'S DECISION IS UNSUPPORTED BY THE AUTHORI- TIES UPON WHICH IT RELIES.	13

	Page
D. THE SIXTH CIRCUIT'S DECISION ATTEMPTS TO CREATE A NON-STATUTORY WASH-SALE RULE.	15
E. SECTION 165 DOES NOT PREVENT DEDUCTION OF PETITIONER'S LOSS.	16
CONCLUSION	17

APPENDIX

1. Court of Appeals Opinion	1a
2. Tax Court Opinion	16a
3. Court of Appeals Judgment Entry/Mandate	57a
4. Court of Appeals Order Denying Rehearing	58a
5. Federal Home Loan Bank Board Memorandum R-49	59a

TABLE OF AUTHORITIES

Cases	Page
<i>Centennial Savings Bank FSB v. United States</i> , 887 F.2d 595 (5th Cir. 1989), <i>rev'g.</i> 682 F. Supp. 1389 (N.D. Tex. 1988)	9
<i>Davis v. Commissioner</i> , 585 F.2d 807 (6th Cir. 1978), <i>cert. denied</i> , 440 U.S. 981 (1979)	14
<i>Federal National Mortgage Association v. Commissioner</i> , 896 F.2d 580 (D.C. Cir. 1990), <i>aff'g.</i> 90 T.C. 405 (1988)	9
<i>First Federal Savings and Loan Association of Temple v. United States</i> , 887 F.2d 593 (5th Cir. 1989), <i>aff'g.</i> 694 F. Supp. 230 (W.D. Tex. 1988)	9
<i>Gregory v. Helvering</i> , 69 F.2d 809 (2d Cir. 1934), <i>aff'd.</i> 293 U.S. 465 (1935)	17
<i>Hanlin v. Commissioner</i> , 108 F.2d 429 (3d Cir. 1939), <i>aff'g.</i> 38 B.T.A. 811 (1938)	12
<i>Horne v. Commissioner</i> , 5 T.C. 250 (1945)	13
<i>Keats v. United States</i> , 865 F.2d 86 (6th Cir. 1988)	14
<i>Owens v. Commissioner</i> , 568 F.2d 1233 (6th Cir. 1977)	14
<i>Perlin v. Commissioner</i> , 86 T.C. 388 (1986)	14
<i>San Antonio Savings Association v. Commissioner</i> , 887 F.2d 577 (5th Cir. 1989), <i>aff'g.</i> 55 T.C.M. (CCH) 813 (1988)	9, 11, 12, 13, 14, 16

	Page
<i>Shoenberg v. Commissioner</i> , 77 F.2d 446 (8th Cir.), <i>cert. denied</i> , 296 U.S. 586 (1935)	13, 14
<i>Sullivan v. United States</i> , 618 F.2d 1001 (3rd Cir. 1980)	17
<i>Thor Power Tool Co. v. Commissioner</i> , 439 U.S. 522 (1979)	13
<i>Widener Trusts v. Commissioner</i> , 80 T.C. 304 (1983), <i>acq.</i> 1984-1 C.B. 2	15
 Internal Revenue Code of 1954	
26 U.S.C. § 165	2, 9, 11, 12, 15, 16
26 U.S.C. § 1031	13, 14
26 U.S.C. § 1091	2, 13, 15, 16
Revenue Act of 1928, Section 118	13
 Treasury Regulations on Income Tax	
26 C.F.R. § 1.165-1(b)	2, 16
26 C.F.R. § 1.165-1(d)	3, 16
26 C.F.R. § 1.1001-1(a)	3, 11
 Miscellaneous	
Federal Home Loan Bank Bd. Mem. No. R-49 (June 27, 1980)	7, 10, 12, 17

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

**PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT**

Petitioner respectfully requests that a Writ of Certiorari be issued to review the decision and judgment of the United States Court of Appeals for the Sixth Circuit entered on December 4, 1989, which reversed the decision of the United States Tax Court granting judgment in favor of Petitioner.

OPINIONS BELOW

The opinion of the Court of Appeals is contained in the Appendix at 1a, and is reported at 890 F.2d 848. The opinion of the Tax Court is contained in the Appendix at 16a, and is reported at 90 T.C. 372.

JURISDICTION

The judgment of the Court of Appeals was entered on December 4, 1989. A Petition for Rehearing was timely filed by the Petitioner on December 29, 1989. The Petition for Rehearing was denied on March 14, 1990. Jurisdiction to review

the judgment of the Sixth Circuit in this cause by a Writ of Certiorari is conferred on this Court by 28 U.S. Code Section 1254(1).

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.)

§ 165 Losses

(a) *General rule.* There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

§ 1091 Loss From Wash Sales of Stock or Securities

(a) *Disallowance of loss deduction.* In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction shall be allowed under section 165 unless the taxpayer is a dealer in stock or securities and the loss is sustained in a transaction made in the ordinary course of such business. For purposes of this section, the term "stock or securities" shall, except as provided in regulations, include contracts or options to acquire or sell stock or securities.

Treasury Regulations on Income Tax (26 C.F.R.)

§ 1.165-1 (b)

(b) *Nature of loss allowable.* To be allowed as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable.

Substance and not mere form shall govern in determining a deductible loss.

§ 1.165-1 (d)

(d) *Year of deduction.* (1) A loss shall be allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. . . . [Remaining portions, which are not pertinent to sales or exchanges, are omitted]

§ 1001-1 Computation of gain or loss.

(a) *General rule.* Except as otherwise provided in Subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001(a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (i.e., the cost or other allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations

thereunder. Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by transfer in trust).

STATEMENT OF THE CASE

Petitioner is a federally insured savings and loan institution subject to the regulations of the Federal Home Loan Bank Board (hereinafter sometimes referred to as the "FHLBB"). On December 31, 1980, Petitioner exchanged some of its mortgage loans (more precisely, participations in such loans) for participations in mortgage loans owned by four unrelated savings and loan institutions located in the Cincinnati and Portsmouth, Ohio areas. The mortgage loans exchanged had declined in value because of increases in mortgage interest rates. As a result of these transactions, Petitioner deducted losses on its tax return for 1980, carried back said losses to earlier years (1974 through 1979), and recovered federal income taxes it had previously paid.

The Internal Revenue Service, disagreeing with Petitioner's tax treatment of this transaction (hereinafter sometimes referred to as "reciprocal mortgage loan transactions" or "reciprocal sales"), issued a statutory notice of deficiency to Petitioner on June 24, 1983, disallowing the deductions. Petitioner filed a petition in the United States Tax Court on September 23, 1983. A trial was held on June 18, 19 and 20, 1985 in Cincinnati.

On March 14, 1988, the Tax Court issued its opinion, reviewed by the entire court (two judges did not participate), holding for the Petitioner and sustaining Petitioner's loss on its reciprocal mortgage loan transactions. The Tax Court held that the Petitioner realized losses in the years under review and that the losses were recognized and deductible for income tax purposes. A decision was entered by the Tax Court on October 3, 1988.

From that judgment, the Internal Revenue Service took its appeal to the United States Court of Appeals for the Sixth Circuit by Notice of Appeal filed on December 30, 1988. After briefing and argument, the Court of Appeals rendered its opinion and judgment on December 4, 1989, reversing the judgment of the Tax Court.

The Court of Appeals agreed with the Tax Court that, in form, Petitioner's reciprocal sales produced an identifiable event that fixed a loss which was both realized and recognized for federal income tax purposes. However, it reversed because it said that no loss was sustained by Petitioner under Section 165 of the Internal Revenue Code.¹ A timely Petition for Rehearing was denied on March 14, 1990.

The basic facts in this case are fully set forth in detail in the Sixth Circuit and Tax Court opinions. As interest rates rose in the late 1970s, savings institutions were caught in a cash squeeze. Money was flowing into higher-yielding money market funds rather than to savings institutions as deposits. Even though their return from loans was low, the market required savings institutions to pay higher and higher interest rates in order to attract new deposits. Earnings declined as interest paid on deposits exceeded the interest earned on long-term fixed-rate mortgage loan portfolios.

Because of the increase in mortgage interest rates, the market values of existing fixed-rate mortgage loan portfolios held by savings institutions, including Petitioner, were substantially less than the book values of these portfolios. Even though Petitioner began offering adjustable rate mortgages in 1980, it continued to experience a drop in new loans as well as in deposits. Petitioner expected this decline in deposits to continue.

Petitioner could have sold its mortgage loan portfolios on the market and thus sustained a loss clearly deductible for federal income tax purposes. However, FHLBB regulations required Petitioner (and other federally insured savings and loan institutions) to meet certain net worth requirements. If Petitioner had merely sold the mortgage loans it transferred, and had been required by the FHLBB's regulatory accounting

¹ Section 165 of the Internal Revenue Code provides, in general, that all losses sustained in a taxable year are deductible unless compensated by insurance or otherwise.

principles ("RAP") to reduce its net worth by the amount of losses it would have sustained on such a sale, the Petitioner's net worth would have been reduced to a level that barely exceeded the FHLBB's minimum requirement.

To relieve this dilemma, the FHLBB in 1980 promulgated a change in its accounting requirements known as "Memorandum R-49" ("R-49").² Under R-49, institutions were no longer required to record such losses from the sale (and repurchase) of mortgage loans on their books. By observing R-49's criteria, savings institutions including Petitioner were encouraged to generate federal income tax refunds by entering into reciprocal sales transactions that produced deductible losses without impairing their net worth. R-49 lists ten criteria, all of which must be satisfied, for mortgage loans involved in reciprocal sales to be considered "substantially identical". The entire text of Memorandum R-49 is set forth in the Appendix. All of the mortgage loans involved in Petitioner's reciprocal sales satisfied the R-49 requirements.

Pursuant to R-49, on December 31, 1980, Petitioner entered into a series of Loan Participation Sale and Trust Agreements with four other savings institutions (three located in Cincinnati and one in Portsmouth, Ohio). In each transaction, checks were paid to and from Petitioner and its trading partners for the current fair market value of the mortgage loans (computed using an interest rate at December 31, 1980 of 14.863 percent). Petitioner then exchanged ninety percent mortgage participation interests in 252 of its mortgage loans and received in return ninety percent mortgage participations in 305 different loans from its trading partners.³

² Federal Home Loan Bank Bd. Mem. No. R-49 (June 27, 1980).

³ Sales of such participations are customary; and loans that are sold or purchased are usually sold or purchased in a group by savings and loans institutions. Participation interests are less liquid than whole loans so as a result of the December 31, 1980 transaction, Petitioner was in a less liquid position (except for its federal income tax refund) than before the transaction.

The participations sold and bought by Petitioner all were in loans that had different obligors, were "conventional" loans secured by mortgages on single-family residences, and were current. The underlying security (real estate) for each loan was different. The Tax Court found that the reciprocal mortgage loan transactions were motivated solely by the desire of Petitioner to recognize for tax purposes (but not regulatory purposes) the losses in market values of the loan portfolios it owned before the December 31, 1980 transactions. The Tax Court further found that the transactions at issue were between independent parties, were closed and completed, and were bona fide.

ARGUMENT

I. REASONS FOR ALLOWANCE OF THE WRIT OF CERTIORARI

This case presents a tax issue of first impression, one in which the Tax Court was in unanimity. The Sixth Circuit agreed with the decision of the Tax Court that Petitioner realized and recognized losses on its reciprocal sales of mortgage loans but held that Petitioner's losses were not deductible under Section 165 of the Internal Revenue Code because they were not sustained. On this issue as well as on the result in this case, the Sixth Circuit is in direct conflict with the Fifth Circuit and the District of Columbia Circuit, both of which affirmed decisions of the Tax Court in cases substantially similar to the instant case.

In *San Antonio Savings Association v. Commissioner*, 887 F.2d 577 (5th Cir. 1989), *aff'g*. 55 T.C.M. (CCH) 813 (1988), the Fifth Circuit Court of Appeals, on essentially the same facts as in this case⁴, agreed with the Tax Court opinion in this case that the losses from reciprocal sales were realized, recognized and sustained. See also *Centennial Savings Bank FSB v. United States*, 887 F.2d 595 (5th Cir. 1989), *rev'g*. 682 F. Supp. 1389 (N.D. Tex. 1988) and *First Federal Savings and Loan Association of Temple v. United States*, 887 F.2d 593 (5th Cir. 1989), *aff'g*. 694 F. Supp. 230 (W.D. Tex. 1988).

The District of Columbia Circuit Court of Appeals in *Federal National Mortgage Association v. Commissioner*, 896 F.2d 580 (D.C. Cir. 1990), *aff'g*. 90 T.C. 405 (1988), on the same issue and on similar facts rejected "the Sixth Circuit's reasoning and result in favor of the more persuasive analysis of the Fifth Circuit and the Tax Court. . ." in this case. 896 F.2d at 584.

⁴ The facts in *San Antonio* are virtually identical to this case as *San Antonio* was decided by the Tax Court on summary judgment based on an assumption that the facts were essentially the same as in this case.

The ultimate decision in this case will affect dozens of savings institutions across the country which have engaged in transactions similar to that in issue here. Conservatively, hundreds of millions of dollars in tax refunds or payments will be affected by the decision in this case. The Tax Court thought this case sufficiently important that its decision was reviewed by the full court.

The reciprocal mortgage loan transaction entered into by Petitioner and its trading partners was completed at a time of crisis in the savings industry. Petitioner, as did savings institutions across the country, entered into this transaction to recognize the actual market-value loss on certain of its mortgage loans in order to generate tax refunds at a time in which savings institutions desperately needed cash to survive. Petitioner sold its mortgages and bought similar but different mortgages from other savings institutions pursuant to FHLBB Memorandum R-49 which was promulgated expressly to permit such reciprocal sales so that savings institutions could realize such market-value losses without impairing their net worth for regulatory accounting purposes.

II. QUESTION PRESENTED FOR REVIEW

Does Section 165 of the Internal Revenue Code, which limits the deduction of losses to those actually sustained, prevent the deduction by a savings institution of a realized and recognized loss on an exchange of different mortgage loan portfolios, where a regulation of the Federal Home Loan Bank Board permits the taxpayer to avoid recording the loss on its books for regulatory accounting purposes?

A. ALL REALIZED LOSSES FROM SALES OR EXCHANGES OF PROPERTY ARE "SUSTAINED" UNDER SECTION 165.

The Sixth Circuit concluded that Petitioner "realized" losses on the exchanges of its mortgages, that those losses must be "recognized," but that they were not deductible under Section 165 because they were not "sustained." This interpretation of the tax law is squarely contradicted by the Internal Revenue Service's own regulation and has been rejected by every other court that has considered mortgage exchange transactions. See, e.g., *San Antonio Savings Association v. Commissioner*, *supra* at 592-93.

The principal regulation dealing with gains and losses from sales and exchanges of property, Treas. Reg. Section 1.1001-1(a), explicitly states that if a taxpayer's amount realized from a sale or exchange is less than his adjusted basis in the property, "a loss is *sustained* to the extent of the difference between such adjusted basis and the amount realized." (Emphasis added.) In addition, the Regulation states that "gain or loss realized . . . from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss *sustained*." Treas. Reg. Section 1.1001-1(a). (Emphasis added.) Thus, according to the Regulation, so long as the property exchanged is

materially different, then every "realized" loss is "sustained".⁵ The Tax Court held that the mortgage loans in this case were materially different, and that Petitioner's loss was thus "sustained". Nothing in Section 165 or the regulations thereunder is contrary to this conclusion.

B. THE SIXTH CIRCUIT'S TEST FOR WHEN A LOSS IS SUSTAINED IS CONTRARY TO PRECEDENT.

The Sixth Circuit held that no losses had been sustained based on two findings: Petitioner (1) received "substantially identical" mortgages in the exchange and (2) did not record the losses on its books (*i.e.*, for nontax regulatory accounting purposes). Appendix at 14a. Both findings are unfounded and contrary to established authority.

With regard to its first finding, the Sixth Circuit apparently viewed the R-49 regulatory accounting criteria as determinative of when two groups of mortgages are "substantially identical" for tax purposes. This approach is directly contrary to *Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939), *aff'g.* 38 B.T.A. 811 (1938), which held that mortgages secured by different underlying properties are not "substantially identical" for tax purposes.⁶ The Tax Court specifically found that the mortgages exchanged by Petitioner were "materially different". The Fifth Circuit in *San Antonio* provides an excellent and detailed explanation of how mortgages could be materially different for tax purposes while substan-

⁵ Judge Cohen, in her concurring opinion in the Tax Court, held that the property exchanged by Petitioner did not have to be materially different in order to sustain a loss.

⁶ Moreover, the holding that the exchanged mortgages were substantially identical in the present case was particularly unwarranted because the Tax Court did not rely solely on *Hanlin's* rule that mortgages with different underlying properties are not "substantially identical"; it went further and, based on the trial record, found as a matter of fact that the exchanged mortgages were likely to (and subsequently did) behave differently. Appendix at 37a.

tially identical for regulatory accounting purposes as well as the weight to be given to the FHLBB's determination of substantial identity. *San Antonio*, *supra* at 591.

The second finding of the Sixth Circuit is equally deficient. Under *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), the treatment of a transaction on a taxpayer's books does not control its tax treatment. Therefore, Petitioner's failure to record the loss on its books is irrelevant.

C. THE SIXTH CIRCUIT'S DECISION IS UNSUPPORTED BY THE AUTHORITIES UPON WHICH IT RELIES.

The Sixth Circuit's decision in this case relies heavily upon *Shoenberg v. Commissioner*, 77 F.2d 446 (8th Cir.), *cert. denied*, 296 U.S. 586 (1935), and *Horne v. Commissioner*, 5 T.C. 250 (1945). This reliance is misplaced. Those cases involved transactions in which a taxpayer disposed of and reacquired the *same* property rights. Thus they are inapplicable to transactions (such as those at issue here) in which indisputably *different* properties were exchanged. Moreover, the results reached in both of those cases were supported by statutory non-recognition rules — the predecessor to Section 1091 in *Shoenberg*⁷ and the predecessor to Section 1031 in *Horne*⁸ — whereas no non-recognition rule is applicable to the transactions at issue here.

⁷ The taxpayer in *Shoenberg* tried to avoid the wash-sale rule in section 118 of the Revenue Act of 1928 by having the stock he sold at a loss immediately repurchased by his controlled corporation, which then waited slightly more than 30 days to sell the stock back to him. The Eighth Circuit stated: "For all practical purposes, he used [his corporation] as an agency for purchasing, holding, and selling to him, stocks identical with those he sold to establish the claimed loss." 77 F.2d at 449 (emphasis added). Under agency principles, the sale and repurchase fell within the statutory wash-sale rule, resulting in the disallowance of the losses at issue.

⁸ The taxpayer in *Horne* purchased one certificate representing a "seat" on a stock exchange and sold another certificate to take a tax loss. The Tax

In addition, the Sixth Circuit improperly extended *Shoenberg's* rationale for denying a loss deduction, viz., that the taxpayer is "no poorer than before the sale" because the identical stock was repurchased. 77 F.2d at 499. The taxpayer in *Shoenberg* was "no poorer" after the transactions because he ended up with the *exact same* property. However, the tax law cannot require — as the Sixth Circuit suggests — that taxpayers be poorer as the result of an exchange involving *different* properties in order for a loss to be deductible; if it did, taxpayers would be entitled to a deductible loss only in the event of a bad bargain. See *San Antonio*, 887 F.2d at 590 ("[r]ealization does not require that a taxpayer must be 'richer or poorer' as a *result of the exchange itself*" [original emphasis]).

The Sixth Circuit also misinterprets the "sham" and "substance-over-form" cases cited in its opinion (none of which is based on Section 165). *Keats v. United States*, 865 F.2d 86 (6th Cir. 1988), involved silver straddle transactions in which the taxpayer suffered no real economic losses; in contrast, it is undisputed that Petitioner suffered *real economic losses* on the mortgages exchanged in its transactions. In *Davis v. Commissioner*, 585 F.2d 807 (6th Cir. 1978), *cert. denied*, 440 U.S. 981 (1979), the court disregarded purported sales of apartment complexes to taxpayers by their wholly owned corporations, concluding the corporations had not in substance transferred the assets to the taxpayers; in contrast, it is undisputed that the subject mortgage participations were actually transferred to new owners by Petitioner. In *Owens v. Commissioner*, 568 F.2d 1233 (6th Cir. 1977), the court held that the purchase for cash of stock

Court held: "[T]he result was the same as if he had exchanged his certificate for that of another member. The deduction of a loss on such an exchange, that is, an exchange of property held for productive use in trade or business for property of a like kind to be held for such use, is expressly denied by section 112(b)(1) of the Internal Revenue Code [now Section 1031(a)(1)]." 5 T.C. at 256. See: *Perlin v. Commissioner*, 86 T.C. 388, 430 n.36 (1986) (characterizing *Horne* as a Section 1031 case).

in a shell corporation whose only asset was cash should be treated as an exchange of cash for cash, rather than a sale of the equity of a business; in contrast, it is undisputed that the assets exchanged by Petitioner were in fact different mortgages.

The case of *Widener Trusts v. Commissioner*, 80 T.C. 304 (1983), *acq.* 1984-1 C.B. 2, is instructive in the reciprocal sale area. In *Widener Trusts*, the Tax Court held that a reciprocal sale of stock between two trusts produced a deductible loss under Section 165 of the Code to each trust, despite each trust's admitted motive to realize tax losses to offset portfolio gains in the same year. *Id.* at 310. Further, the court found that even though both trusts had the same beneficiary, they were not related in a tax sense but were separate taxpayers, and that the sales had substance because each trust permanently terminated its ownership of the stocks sold and the income flow they produced. *Widener Trusts*, 80 T.C. at 313. Petitioner, like the taxpayer in *Widener Trusts*, entered into an arms-length transaction that resulted in a change in the flow of economic benefits. Just as in *Widener Trusts*, Section 165 should not prevent Petitioner's deduction of its losses.

D. THE SIXTH CIRCUIT'S DECISION ATTEMPTS TO CREATE A NON-STATUTORY WASH-SALE RULE.

The Sixth Circuit applies a standard that is tantamount to a non-statutory "wash-sale" rule within the framework of Section 165. The statutory wash-sale rule of Section 1091 denies loss deductions where a taxpayer sells or otherwise disposes of "stock or securities" and, within 30 days before or after such an event, acquires "substantially identical" stock or securities. Because mortgages are not stock or securities, Section 1091 cannot be applied in this case, and the Internal Revenue Service has not contended otherwise.* The Sixth Circuit's deci-

* The government conceded that none of the non-recognition sections of subtitle A of the Internal Revenue Code (which includes Section 1091) apply to this case.

sion effectively ignores Section 1091's limitation to stock or securities. This approach makes the statutory limitation meaningless, frustrating the clear intent of Congress and creates a judicially imposed nonstatutory wash-sale rule for mortgage transactions.

E. SECTION 165 DOES NOT PREVENT DEDUCTION OF PETITIONER'S LOSS.

Section 165 of the Code provides, in general, that all losses sustained in a taxable year are deductible unless compensated by insurance or otherwise. The Regulations refine this rule to provide that a loss must be evidenced by a closed and completed transaction, must be fixed by an identifiable event, and must be bona fide. Treas. Reg. Section 1.165-1(b) and (d). The Regulations further provide that in determining the existence of these factors, substance shall control and not form. Treas. Reg. Section 1.165-1(b). The Fifth Circuit in *San Antonio* concurred with the Tax Court's finding in this case that the transaction was closed and completed, changed the flow of economic benefits, and did not lack economic substance.

The Fifth Circuit in *San Antonio* then stated that Section 165 and Treas. Reg. Section 1.165-1(b) simply do not apply to the facts of this case.

The government's argument with reference to § 165 is a different facet of its previous argument that the loss sustained by SASA was not economically real. Even if it is conceded (as it was for summary judgment purposes) that there was no purpose for the R-49 transaction other than tax reduction, nevertheless SASA suffered a real economic reduction in the value of the mortgage participation interests it transferred and the economic reality of that loss was fixed by an identifiable event, an exchange of materially different items.

San Antonio, 887 F.2d at 592.

It is well settled that taxpayers are entitled to arrange their affairs to minimize taxes. *Gregory v. Helvering*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). *See also Sullivan v. United States*, 618 F.2d 1001, 1007-1008 (3rd Cir. 1980) (which held that "there is nothing sinister in arranging one's affairs so as to minimize taxes.") Taxpayer in this case merely chose the time it wished to take its loss and minimize its taxes. Memorandum R-49 permitted taxpayer to do so by exchanging its mortgage loans for similar, but different loans and, at the same time, avoid recording the loss on its books.

Taxpayer sustained a real, economic loss, which loss was realized, recognized and should be allowed for income tax purposes. This Court should adopt the proper reasoning of the Fifth Circuit (and D.C. Circuit) and reject the reasoning of the Sixth Circuit Court of Appeals.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari be granted.

Respectfully submitted,

SCHWARTZ, MANES & RUBY

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APPENDIX

No. 89-1036
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

COTTAGE SAVINGS ASSOCIATION,
Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

Decided and Filed December 4, 1989

Before: WELLFORD and NORRIS, Circuit Judges; and LIVELY,
Senior Circuit Judge.

LIVELY, Senior Circuit Judge. This appeal requires us to decide whether a savings association is entitled to a loss deduction under the Internal Revenue Code¹ as a result of "reciprocal sales" of depreciated mortgage loans to other thrift institutions. The Commissioner of Internal Revenue disallowed the deductions and asserted deficiencies in corporate income tax for the years 1974 through 1980. Upon petition for redetermination of deficiencies, the Tax Court found that the petitioner, Cottage Savings Association, realized losses in the years under review and that the losses are

¹ As used in this opinion, "the Code" refers to the Internal Revenue Code of 1954, as amended.

2a

recognized and deductible for income tax purposes. The Commissioner appeals, and we reverse.

I.

A.

One of the problems experienced by thrift institutions in recent years resulted from their historic practice of making long term mortgage loans at fixed interest rates. As interest rates rose in the late 1970s such institutions were caught in a cash squeeze. Their return from loans was low, but the current market required them to pay interest at higher and higher rates in order to attract new deposits. In addition, many savings institutions lost substantial amounts of deposits to higher-yielding money market funds and similar investment vehicles. Even though Cottage began offering adjustable rate mortgages in 1980, in common with other similar institutions, it continued to experience a drop in new loans and deposits.

The practice of generating losses by means of "reciprocal sales" resulted from a change in accounting requirements promulgated in 1980 by the Federal Home Loan Bank Board (FHLBB) as "Memorandum R-49." Prior to the issuance of R-49, the FHLBB's regulatory accounting principles required institutions to reduce their net worth by the amounts of any losses sustained in the sale of loans at less than book value. Under R-49, the institutions no longer were required to record such losses. By observing R-49's criteria, savings associations attempted to generate income tax refunds by entering into "reciprocal sales" transactions that produced deductible losses without impairing net worth. Based on "reciprocal sales" transactions with four other Ohio savings institutions on December 31, 1980, Cottage claimed losses on its 1980 corporate income tax return from sales of mortgage loans at less than book value. However, under R-49 it recorded no losses for accounting purposes. The resulting income tax refunds claimed for 1980 and carry-back years exceeded \$677,000.

3a

B.

R-49 lists ten criteria, all of which must be satisfied, for mortgage loans involved in reciprocal sales to be considered "substantially identical," and thus to qualify for special treatment. The sales must:

1. involve single-family residential mortgages,
2. be of similar type (e.g., conventionals for conventionals),
3. have the same stated terms of maturity (e.g., 30 years),
4. have identical stated interest rates,
5. have similar seasoning (i.e., remaining terms of maturity),
6. have aggregate principal amounts within the lesser of 2½% or \$100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

All of the mortgage loans involved in Cottage's December 31, 1980, transactions satisfied the R-49 requirements. These transactions consisted of the sale of 252 loans to the four reciprocating institutions and the purchase of 305 loans from the same associations. The institutions exchanged checks on December 31, with the purchaser paying the seller in each instance a discounted price for the loans, reflecting the difference between the then-current interest rate (14.863 percent) and the rates at which the loans had been made. The institutions did not actually sell whole loans; instead, they sold "90 percent participations" in each loan, with the seller re-

taining a 10 percent interest in each loan. The original lender continued to service the loans, with the borrowers making payments to that institution. Payments were then remitted to the purchasing association. It was stipulated that Cottage did not investigate the credit ratings of any of the borrowers on the loans it received in the transactions and did not inspect the real estate that secured the loans. The recording and tax treatment of the transactions were based on the single premise that the package of mortgage loans sold and purchased satisfied the criteria of R-49.

II.

A.

The government makes two basic arguments on appeal. First, it argues that the "reciprocal sales" were actually exchanges and that they did not satisfy the Code requirements for realization of loss upon the exchange of property. The government maintains that the Code and applicable Treasury Regulations treat a loss as realized only if the property exchanged is materially different. Since R-49 requires that the loans which are the subject of "reciprocal sales" be "substantially identical," they necessarily are not materially different.

Second, unless the "materially different" requirement is met, although a loss is "realized" in a reciprocal sales transaction, it is not deductible as a loss "sustained." No loss is sustained for income tax purposes if a transaction resulting in loss lacks economic substance. Since Cottage merely exchanged one pool of mortgage loans whose market value had fallen below their book value for a similar pool of loans, matched exactly as to interest rates and maturity dates, and reflected no loss for accounting purposes, there was no economic substance to the transaction.

B.

Cottage agrees that "realization" is the key issue in determining whether it is entitled to a loss deduction. According to Cottage, transfer of the mortgage loans resulted in a realized

loss regardless of whether the mortgage loans transferred and received materially differed from each other. While conceding that mere increase or decrease in the value of a taxpayer's property does not result in income or loss, Cottage contends that it is different when the increase or decrease is "realized" in a completed transaction. When it results from an exchange rather than from a sale, a loss is realized, regardless of whether the properties exchanged are materially different.

While denying the existence of such a requirement, Cottage maintains that if exchanged properties must be materially different for a loss to be realized, that requirement was met in the December 31, 1989, transaction. The exchanged mortgages had different obligors and were secured by different parcels of real estate. They met R-49's "substantially identical" criteria respecting interest rates, maturities and similar features, but were nonetheless materially different because the presence of different obligors and different security meant that there were different risk factors.

Cottage argues that any realized loss is recognized for income tax purposes unless it falls within a statutory exception, and the "reciprocal sales" transactions do not fall within an exception.

Finally, Cottage argues that the transactions had economic substance. The mortgages had already suffered a decline in market value and this decline was converted into a realized loss by the transfer of the mortgages to a third party in a completed transaction. The fact that Cottage simultaneously purchased mortgage loans that satisfied the R-49 criteria from the transferees is irrelevant; the loss was realized, and it was recognized and deductible.

III.

A.

The Tax Court concluded that the transactions between Cottage and the four associations were exchanges, and that properties exchanged must be materially different for a loss to

be deductible. *Cottage Savings Association v. Commissioner*, 90 T.C. 372 (1988). A majority of the Tax Court applied Code section 1001(a) and Treas. Reg. 1.1001-1(a) in reaching this conclusion. Code section 1001 provides:

§ 1001. Determination of amount of and recognition of gain or loss

(a) Computation of gain or loss

The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

26 U.S.C. § 1001(a)

The Tax Court also relied upon the opening sentence in Treas. Reg. 1.1001-1(a):

§ 1.1001-1 Computation of gain or loss.

(a) *General rule.* Except as otherwise provided in Subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

26 C.F.R. 1.1001-1(a). The remainder of subsection (a) deals exclusively with computation. Based on its conclusion that an exchange of properties produces a realized loss only if the properties are materially different and its determination that the mortgage loans involved in the December 31, 1980, transactions satisfied this requirement, the Tax Court majority held that Cottage's 1980 loss was recognizable and deductible.

Judge Cohen, joined by four other members of the Tax Court, concurred in the decision in *Cottage*, but reached her conclusion on a different basis. 90 T.C. at 403-04. She viewed Treas. Reg. 1.1001-1(a) as dealing with the computation of

gain or loss rather than establishing a rule for determining whether gain or loss has been realized or recognized. Therefore, the reference in Treas. Reg. 1.1001-1(a) to "property differing materially either in kind or in extent" cannot be treated as creating a requirement for realization or recognition.

In her view, § 1001(c) controls the determination of whether gain or loss is recognized. That section provides:

(c) Recognition of gain or loss

Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

26 U.S.C. § 1001(c). Finding no provision to the contrary, Judge Cohen concluded that the exchange of pools of mortgage loans was an identifiable event that fixed the amount of loss, which § 1001(c) requires to be recognized.

B.

The Tax Court has applied the *Cottage* majority's reasoning in allowing the deduction of losses arising from "reciprocal sales" in subsequent cases. See *Federal National Mortgage Association v. Commissioner*, 90 T.C. 405 (1988), decided the same day as *Cottage*, *San Antonio Savings Association v. Commissioner*, T. C. Memo. 1988-204 (1988); *Leader Federal Savings and Loan Association of Memphis v. Commissioner*, T. C. Memo. 1989-321 (1989).

Two district courts in Texas have taken different approaches to the issue and have reached opposite conclusions. In *Centennial Savings Bank FSB v. United States*, 682 F. Supp. 1389 (N.D. Tex. 1988), the court concluded that Treas. Reg. 1.1001-1(a) applied to a "reciprocal sale" transaction and interpreted the regulation as requiring that properties exchanged in the transaction be materially different before a loss will be realized. *Id.* at 1398. The court found, however, that mortgage loans matched under R-49 did not differ

materially and disallowed the deduction. Since Centennial did not consider individual differences in mortgage loans and the market place treated the mortgage pools alike, the individual differences lacked "economic relevance." *Id.* at 1399.

The district court also held that Centennial did not experience a real change in economic condition by reason of its R-49 transactions. Although its mortgages had declined in value, after the R-49 transaction, Centennial was no poorer than before. There had been no event that made the taxpayer "poorer to the extent of the loss claimed." *Id.* at 1400, quoting *Shoenberg v. Commissioner of Internal Revenue*, 77 F.2d 446, 449 (8th Cir.), *cert. denied*, 296 U.S. 586 (1935). The loss was suffered as current interest rates drove down the market value of Centennial's mortgage loans; it did not occur when the discounted mortgage loans were exchanged with other associations for similar mortgage loans.

Reaching a different conclusion, the court allowed a loss deduction in *First Federal Savings and Loan Association of Temple v. United States*, 694 F.Supp. 230 (W.D. Tex. 1988). The court found that an R-49 transaction in which Temple transferred 360 mortgage loans to a Waco association and acquired 287 loans from that association was an exchange, even though structured as a "reciprocal sale." The exchange involved two pools of mortgage loans rather than individual loans. *Id.* at 236. The court found that Temple realized a loss under § 1001 because the transaction was an identifiable event that fixed the decline in value of the mortgages transferred. The decline in value was fixed as of the time of the R-49 transaction and it was immaterial that the taxpayer was in no worse economic position after the transfer than before. *Id.* at 239-42. The court found that the mortgages involved were not materially different, *id.* at 244, but concluded that this fact did not prevent the exchange from producing a realized loss. *Id.* at 242, 249.

The *Temple* court did not stop with its analysis of the realization requirement. It stated that recognition, not realization, was the critical issue. *Id.* at 232 n.2. It noted that

§ 1001(c) requires recognition of any gain or loss determined under § 1001(a) and (b) in the absence of a provision to the contrary. Treas. Reg. 1.1002-1 provides for strict construction of exceptions to the general rule requiring recognition of all gains and losses. There is no exception concerning non-recognition of gains or losses from an exchange of loans, notes, or evidences of indebtedness. *Id.* at 247. Since no contrary provision applies to exchanges of mortgage loans, § 1001(c) is dispositive. *Id.* at 246.

Federal National Mortgage Association v. Commissioner is on appeal to the Court of Appeals for the District of Columbia and the two Texas cases have been appealed to the Fifth Circuit Court of Appeals. Neither court has rendered a decision at the time of preparation of this opinion.

IV.

A.

Our approach to this case differs from that of the other courts that have considered the issue. We agree with Judge Cohen that § 1001(a) deals only with the computation of the amount of gain or loss, not whether a gain or loss is realized. Further, it does not prescribe a rule for determining whether a gain or loss will be recognized. That determination is controlled by § 1001(c), the recognition provision. In our view, the inquiry does not stop with a determination that a loss is recognizable; it must also be deductible under § 165, which deals comprehensively with the income tax treatment of losses. Section 165(a) provides:

(a) **General Rule.** There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

26 U.S.C. § 165(a). Read together, §§ 1001(c) and 165(a) appear to provide that any recognizable loss sustained during a taxable year is deductible unless otherwise compensated. The nature of the loss allowed is set forth in Treas. Reg. 1.165-1(b):

(b) *Nature of loss allowable.* To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance, and not mere form shall govern in determining a deductible loss.

26 C.F.R. § 1.165-1(b).

We believe the loss in this case was technically realized in the sense that an earlier decline in value of the fixed-rate mortgage loans was fixed by an identifiable event — the “reciprocal sales” transaction. Since there is no Code exception that applies, under § 1001(c) the loss must be recognized. The remaining question is whether an actual loss was sustained for income tax purposes so as to be deductible under § 165.

B.

It is clear that a taxpayer's motive in entering into a transaction resulting in a loss does not control deductibility. A taxpayer may reduce the amount of tax otherwise due, or avoid it altogether, “by [any] means which the law permits.” *Gregory v. Helvering*, 293 U.S. 465, 469 (1935). What is done for the purpose of tax avoidance must, however, have some business purpose and not be an economic transaction in form only. The courts will not “exalt artifice above reality.” *Id.* at 470.

Shortly after the Supreme Court decided *Gregory*, the Eighth Circuit Court of Appeals applied the teachings of *Gregory* in a case involving the sale and purchase of corporate stocks. In *Shoenberg v. Commissioner of Internal Revenue*, 77 F.2d 446 (8th Cir.), *cert. denied*, 296 U.S. 586 (1935), the taxpayer devised a plan involving related but separate transactions in order to avoid the “wash sale” provision of the Code. Under § 1091, a loss on the sale of shares of stock or

other securities may not be deducted where the seller acquires substantially identical stock or securities within 30 days before or after the sale. 26 U.S.C. § 1091. The purpose of this provision is to prevent deductions for fictitious losses and to require that there be a change in the economic position of the taxpayer. *Hanlin v. Commissioner of Internal Revenue*, 108 F.2d 429, 430 (3d Cir. 1939).

The taxpayer in *Shoenberg* sold individually owned corporate stocks through a broker on December 5, 1930. The same day the broker purchased equal shares of the identical stocks for the same prices in the name of an investment company controlled by the taxpayer. Slightly more than 30 days thereafter the taxpayer purchased the stocks from the investment company at the current market price, slightly below the price at which he had sold them through the broker. The taxpayer claimed a loss on his 1930 income tax return based on the December 5 sale of the stocks at prices below his tax basis. The court agreed with the taxpayer that there was an actual sale. This satisfied the requirement that the loss be “realized” by some completed “identifiable event.” *Id.* at 448. However, the court concluded that it could look beyond the form to the substance of the entire transaction. In denying the deduction, the court stated:

To secure a deduction, the statute requires that an actual loss be sustained. An actual loss is not sustained unless when the entire transaction is concluded the taxpayer is poorer to the extent of the loss claimed; in other words, he has that much less than before.

A loss as to particular property is usually realized by a sale thereof for less than it cost. However, where such sale is made as part of a plan whereby substantially identical property is to be reacquired and that plan is carried out, the realization of loss is not genuine and substantial; it is not real. This is true because the taxpayer has not actually changed his position and is no poorer than before, the sale. The particular sale may be real, but the entire transaction prevents the loss from being actually

suffered. Taxation is concerned with realities, and no loss is deductible which is not real.

Id. at 449.

The Tax Court employed similar reasoning in *Horne v. Commissioner of Internal Revenue*, 5 T.C. 250 (1945). Although the property sold and bought — a seat on a commodities exchange — was not covered by the “wash sale” provision of the Code, the court disallowed a claimed deduction. The court stated:

Underlying all of the loss deduction provisions of the statute is the concept of a financial detriment actually suffered by the taxpayer. Before any deduction is allowable there must have occurred some transaction which when fully consummated left the taxpayer poorer in a material sense.

Id. at 254.

In determining the tax consequences of a transaction, this court considers substance over form and examines the total context of the transaction. In *Johnson v. Commissioner of Internal Revenue*, 495 F.2d 1079 (6th Cir.), *cert. denied*, 419 U.S. 1040 (1974), the taxpayers were held liable for capital gain taxes as the result of a series of transactions. The taxpayers transferred appreciated but encumbered stocks to a trust, which in turn assumed the debt secured by the stocks. After noting that tax liability is determined by the substance rather than the form of a transaction, the court stated:

When one overall transaction transferring property is carried out through a series of closely related steps, courts have looked to the essential nature of the transaction rather than to each separate step to determine tax consequences of the transfer.

Id. at 1082.

This court has consistently disallowed loss deductions based on transactions in which the taxpayer's economic position was

not changed for the worse. In *Owens v. Commissioner of Internal Revenue*, 568 F.2d 1233 (6th Cir. 1977), Judge Peck wrote for the court:

What the law does not permit a taxpayer to do in seeking to avoid taxes is to cast transactions in forms when there is no economic reality behind the use of the forms. “The incidence of taxation depends upon the substance of a transaction. . . . To permit the true nature of a transaction to be disguised by mere formalism, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.” *Commissioner of Internal Revenue v. Court Holding Co.*, 324 U.S. 331, 334, 65 S. Ct. 707, 708, 89 L.Ed. 981 (1945). See *Gregory v. Helvering*, *supra*, 293 U.S. 465, 55 S. Ct. 266, 79 L.Ed. 596; *Union Planters National Bank v. United States*, 426 F.2d 115, 117 (6th Cir.), *cert. denied*, 400 U.S. 827, 91 S. Ct. 53, 27 L.Ed.2d 56 (1970).

Id. at 1237. Judge Peck further bolstered his conclusion that an attempted pass-through of deductions generated by a “Subchapter S” corporation did not produce deductible losses for the taxpayer by quoting one of Judge Learned Hand's trenchant dissents:

“The Income Tax imposes liabilities upon taxpayers based upon their financial transactions, and it is of course true that the payment of the tax is itself a financial transaction. If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for *we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose.*” (Emphasis supplied.)

Gilbert v. Commissioner of Internal Revenue, 248 F.2d 399, 410, 411 (2d Cir. 1957) (Hand, J., dissenting.).

Id. at 1240.

The court reached the same result in *Davis v. Commissioner of Internal Revenue*, 585 F.2d 807 (6th Cir. 1978), *cert. denied*, 440 U.S. 981 (1979), where a transaction that appeared to produce realized losses was found to be a sham. More recently this court agreed with the Commissioner that a series of "straddle" transactions in silver from which a taxpayer claimed losses were shams. The loss deduction was disallowed because the transactions had no economic substance beyond producing tax losses. *Keats v. United States*, 865 F.2d 86 (6th Cir. 1988). Citing *Gregory*, *Davis*, and *Owens*, the *Keats* court found two settled rules respecting claims for deduction of losses: "(1) that claimed deductions may properly be disallowed by the IRS even though the relevant transactions actually occurred as represented by the taxpayer, and (2) that non-tax economic substance must inhere in the relevant transactions before loss deductions will be allowed." *Id.* at 88.

CONCLUSION

We agree with the *Centennial* court that a savings institution is not entitled to deduct losses from the sale of a pool of mortgage loans at prices below book value when the transaction is part of a "reciprocal sale" under which the institution acquires a pool of substantially identical mortgage loans. We do not agree with *Centennial*, however, that the determining factor is the lack of a material difference in the properties sold and purchased. In form, Cottage's "reciprocal sales" produced an identifiable event that fixed the amount of decline in the value of the mortgage loans that it transferred. Because Cottage received a substantially identical pool of mortgages in exchange, however, and did not record the decline on its books, it was not "poorer to the extent of the loss claimed." *Shoenberg*, 77 F.2d at 449. When the entire transaction is considered, it is clear that Cottage's economic position was not changed by the "reciprocal sales." Under these cir-

cumstances, there can be no deduction because no loss has been sustained. A loss is deductible only if specifically authorized by the Code, and § 165 limits deductibility to losses actually sustained.

The petition for review is granted, and the decision of the Tax Court is reversed.

UNITED STATES TAX COURT

COTTAGE SAVINGS ASSOCIATION,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

Docket No. 27487-83.

Filed March 14, 1988.

Petitioner, a regulated savings and loan institution, entered into reciprocal sales and purchases of loan participations with four other unrelated savings and loan institutions. These transfers were at then-current fair market values, substantially below petitioner's bases in the loans. Although the transfers were bona fide, they were made solely to produce losses for Federal income tax purposes, in amounts great enough to result in net operating loss carrybacks which generated substantial Federal income tax refunds. Pursuant to a ruling of the Federal Home Loan Bank Board (Memorandum R-49), petitioner did not recognize the claimed losses for regulatory accounting purposes.

Held: Petitioner realized losses on the transfers; these losses are recognized for Federal income tax purposes and are deductible. Secs. 1001, 165, I.R.C. 1954.

*Dennis L. Manes, Scott M. Slovin, and Richard M. Schwartz, for the petitioner.**

* Briefs amici curiae were filed by Richard L. Bacon and Thomas A. Pfeiler (as attorneys for the United States League of Savings Institutions), by Robert W. Minor, George N. Corey, and Aaron Rosenfeld (as attorneys for the Ohio Savings & Loan League), and by Martin S. Schwartz and Aaron M. Peck (as attorneys for the California League of Savings Institutions).

Joseph R. Goeke and Mary Helen Weber, for the respondent.

CHABOT, *Judge:* Respondent determined deficiencies in Federal corporate income tax against petitioner for 1974 through 1980, as follows:

Year	Deficiency
1974	\$ 47,029.09
1975	62,889.23
1976	102,014.57
1977	154,520.26
1978	185,427.59
1979	54,187.23
1980	73,752.53

After a concession by petitioner,¹ the issue for decision² is whether petitioner realized recognizable losses from sales of 90-percent participations in loan portfolios to other savings and loan institutions, from which petitioner simultaneously acquired 90-percent participations of approximately equal aggregate value and, if so, whether petitioner may deduct those losses.

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulations and the stipulated exhibits are incorporated herein by this reference.

When the petition was filed in the instant case, petitioner's principal place of business was in Cincinnati, Ohio.

¹ By a stipulation filed on December 29, 1986, an adjustment relating to dividends on withdrawable savings has been conceded by petitioner; the concession may be withdrawn if, before we file our opinion in the instant case, the Court of Appeals for the Seventh Circuit has rendered an opinion reversing our decision in *Colonial Savings Association v. Commissioner*, 85 T.C. 855 (1985).

² The notice of deficiency adjustments relating to bad debts and charitable contributions are derivative and depend on the resolution of the issue for decision.

Background

Since 1883, petitioner has been in the business of receiving savings deposits from the public and in turn making loans secured by residential and commercial real estate. Petitioner profited by making loans from deposits at interest rates higher than petitioner paid to depositors, and from charging points for the origination of such loans. Petitioner, a State-chartered mutual savings association, was a federally insured savings and loan institution subject to the regulations of the Federal Home Loan Bank Board (hereinafter sometimes referred to as "the FHLBB"). Petitioner was required to file semiannual financial reports to the FHLBB reporting petitioner's financial condition in conformity with accounting principles adopted by the FHLBB and commonly referred to as regulatory accounting principles (hereinafter sometimes referred to as "RAP").

For 1980 and all the other years in issue (see n. 6, *infra*), petitioner filed its income tax returns on a calendar-year basis and used the accrual method of accounting for all purposes.

In 1980, savings and loan deposits were declining because funds were being diverted to higher-yielding money market funds. Earnings of savings and loan institutions declined as interest paid on deposits exceeded the interest earned on loan portfolios. In addition, because of the increases in market interest rates, the market values of existing fixed-interest loan portfolios held by savings and loan institutions were substantially less than the book values of these loan portfolios.

In 1980, petitioner began to offer adjustable-rate mortgages, which would allow interest rates to be adjusted to meet changes in the market. The number and dollar volume of loans made by petitioner dropped, however. Petitioner experienced a shortage of funds because of the loss of deposits to money market mutual funds and because high interest rates charged by the FHLBB eliminated the FHLBB as a source of funds that petitioner could use to make profitable loans. Petitioner expected the decline in deposits to continue.

FHLBB regulations required petitioner (and other federally

insured savings and loan institutions) to meet certain net worth requirements. These requirements were revised by amendments published on November 6, 1980, with an effective date of November 17, 1980.

If petitioner had sold the loan participations described *infra*, and had been required by the FHLBB's RAP to reduce its net worth by the amounts of the losses that it would have sustained (in table 4, *infra*, compare the last two columns; in table 5, *infra*, compare column (3) with column (4)), then petitioner's net worth would have been reduced to such a level that it would barely exceed the FHLBB's minimum requirements.

Memorandum R-49

On June 27, 1980, the Director of the Office of Examination and Supervision (OES) of the FHLBB issued Memorandum R-49 relating to "reciprocal sales" of mortgage loans, with the following stated synopsis: "A LOSS NEED NOT BE RECORDED FROM 'RECIPROCAL SALES' OF SUBSTANTIALLY IDENTICAL MORTGAGE LOANS". The body of Memorandum R-49 states as follows:

The purpose of this memorandum is to advise OES staff on the proper accounting for reciprocal sales of mortgage loans.

A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded [under RAP]. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:

1. involve single-family residential mortgages,
2. be of similar type (e.g., conventionals for conventionals),
3. have the same stated terms to maturity (e.g., 30 years),

4. have identical stated interest rates,
5. have similar seasoning (i.e., remaining terms to maturity),
6. have aggregate principal amounts within the lesser of 2½ % or \$100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

When the aggregate principal amounts are not the same and the principal amount of the mortgage loans purchased is greater than the principal amount of the mortgage loans sold, the purchaser should record the additional principal. The difference between the additional principal and the additional cost should be recorded as a discount and amortized over a period of not less than ten years. If the principal amount of the mortgage loans purchased is less than the principal amount of those originally sold, the purchaser should reduce its loan account. The difference between the reduction in loans and the amount of cash received should be charged to loss on sale of mortgage loans.

If a reciprocal sale does not meet all of the above criteria, the institution must record losses resulting from the sale.

Memorandum R-49 was the FHLBB's response to a desire of the savings and loan industry to structure exchanges of mortgage loans to create losses for income tax reporting purposes which would not be reported under RAP or under generally accepted accounting principles (hereinafter sometimes referred to as "GAAP").

The criteria selected in Memorandum R-49 represented an attempt by the FHLBB, OES, to maintain the regulated institution's position with respect to three types of risk in a loan portfolio. These risks related to credit or collectibility, rate or future earnings potential, and repayment or extent of principal repayments and prepayments. In the opinion of the OES, a change in any of these risks would change the economic factors underlying a savings and loan institution's loan portfolio and, as a result, require recording the resulting gain or loss under RAP.

A memorandum dated August 10, 1981, from the Director of the OES to the Executive Staff Director of the FHLBB, sets forth the following explanation with respect to the criteria listed in Memorandum R-49.

When developing the criteria contained in Memorandum R-49, we worked closely with the AICPA Committee on Savings and Loan Associations. In addition to communication with this committee, we also obtained agreement with our stance from prominent CPAs serving the industry. * * * Our objective at that time was to structure a transaction which was as close as possible to the IRS "materially different" definition which would still not change the economic position of the association after it engaged in the swap. It was and remains our opinion that Memorandum R-49 represents a transaction which is on a fine line between "substantially identical" and "materially different".

These criteria represented our attempt to maintain the association's position with respect to the three types of risks in a loan portfolio. These risks relate to credit (collectibility), rate (future earnings potential), and repayment (extent of principal repayments and prepayments). In our opinion, a change in any of these risks would change the economic factors underlying an association's loan portfolio and, as a result, require recording the resulting gain or loss.

The following schedule relates the ten criteria for non-recognition, as outlined in Memorandum R-49, to these types of risks.

Criteria	Risk		
	Credit	Rate	Repayment
1) involve only single family residential mortgages	X		X
2) are similar type (conventional vs insured)	X		X
3) same stated terms to maturity (i.e. 29 yrs.)			X
4) identical stated interest rates		X	X
5) similar seasoning			X
6) aggregate principal amounts within 2½ % or \$100,000, with difference made up in cash	X	X	X
7) sold without recourse	X		
8) similar fair market values	X	X	X
9) similar loan to value ratio at time of maturity	X		
10) security properties in same state			X

These criteria vary in importance and effect in achieving the desired objective (i.e. assuring that risk does not transfer). However, it is OES's opinion that all are necessary in their present form to structure the transaction which does not trigger a loss under GAAP.

Transactions in Issue

Before and during 1980, the independent accounting firm engaged by petitioner was Frank Milostan and Associates

(hereinafter sometimes referred to as "Associates").³ In October, 1980, Frank Milostan (hereinafter sometimes referred to as "Milostan") of Associates attended a week-long seminar given by an accounting firm in Houston, Texas. This seminar concerned the banking and savings and loan industries. At this seminar, Milostan was introduced to the concept of reciprocal loan sales. On his return to Cincinnati, Milostan asked the staff of Associates to consider the benefits of such a concept to Associates' clients.

On November 6, 1980, Associates gave a seminar in which the speakers highlighted the use of reciprocal sales to obtain refunds of Federal income taxes. The registration form mailed to Associates' clients and to the other savings and loan institutions which were invited to the seminar captioned the seminar "1980 TAX STRATEGIES FOR FINANCIAL INSTITUTIONS (Your Contribution to the National Debt!!)". Petitioner's president, William C. Kordis (hereinafter sometimes referred to as "Kordis"), was invited to attend on behalf of petitioner, and he and at least one other officer of petitioner attended the seminar.

Before attending the seminar, Kordis had discussed with Milostan the possibility of reciprocal sales of mortgage loans as a method of obtaining cash flow resulting from tax refunds. After the seminar, Kordis discussed with petitioner's board of directors the possibility of entering into such transactions, and invited Milostan to come and explain the possibility in more depth to the board of directors. On November 10, 1980, Milostan and Stanley Quay (an associate of Milostan) discussed reciprocal sale transactions with petitioner's board of directors, and on that date the board of directors passed the following resolution to enter into such transactions:

RESOLVED: To enter into reciprocal sales of mortgage loans to other non-related financial institutions in ex-

³ Associates did the legally required audit work for petitioner. Associates also prepared petitioner's tax returns and provided petitioner with consulting services and advice as to improving petitioner's profitability.

change for mortgage loans of identical interest rates, stated maturities and seasoning. The reciprocal sale of mortgage loans will not result in a gain or loss for financial [sic] reporting purposes. (R-49) However, the reciprocal sale of mortgage loans will result in an ordinary loss for Federal Income Tax purposes equal to the difference between the book value of the portfolio sold and the fair market value of the portfolio purchased on the date of sale. (Revenue Ruling 71-558)

On December 31, 1980, petitioner as "Seller" entered into a series of Loan Participation Sale and Trust Agreements as shown in table 1.

Table 1

Buyer	No. of Loans	Total Consideration
Rosemont Savings Assoc.	8	\$ 99,388.66
Civic Savings Assoc.	44	655,575.72
First Financial Savings Assoc.	188	3,432,714.35
Kenwood Savings and Loan Assoc.	12	271,176.09

Also on December 31, 1980, petitioner as "Buyer" entered into a series of Loan Participation Sale and Trust Agreements as shown in table 2.

Table 2

Seller	No. of Loans	Total Consideration
Rosemont Savings Assoc.	8	\$ 98,257.50
Civic Savings Assoc.	45	655,488.29
First Financial Savings Assoc.	240	3,431,868.28
Kenwood Savings and Loan Assoc.	12	271,298.43

Rosemont Savings Association, First Financial Savings Association, and Kenwood Savings and Loan Association are Ohio corporations located in Cincinnati, Ohio. Civic Savings Association is an Ohio corporation with its principal offices in Portsmouth, Ohio. (These four associations are hereinafter sometimes collectively referred to as "petitioner's trading partners".)

Each of petitioner's trading partners was unrelated to petitioner, was run by other people, and had a board of directors that was separate from that of any of the other of petitioner's trading partners.

In each of the transactions described in table 1 or table 2, *supra* (hereinafter sometimes referred to as "the December 31, 1980, transactions"), the "Buyer" delivered to the "Seller" a check for the total consideration stated in the applicable agreement. Checks were thus exchanged on December 31, 1980, as shown in table 3.

Table 3

Savings and Loan Institution	Amount Paid to Petitioner	Amount Paid by Petitioner
Rosemont Savings Assoc.	\$ 99,388.66	\$ 98,257.50
Civic Savings Assoc.	655,575.72	655,488.29
First Financial Savings Assoc.	3,432,714.35	3,431,868.28
Kenwood Savings and Loan Assoc.	271,176.09	271,298.43
Total	<u>\$4,458,854.82</u>	<u>\$4,456,912.50</u>

No other cash payments were made between petitioner and petitioner's trading partners as consideration for the reciprocal sales.

Each of the December 31, 1980, transactions was at then-current fair market values. The then-current interest rate used in computing these fair market values was 14.863 percent. The loans, participations in which were sold by petitioner, had declined in value before the sales.

Table 4 presents information about the loans that were the subjects of the 90-percent participation transfers from petitioner to Civic Savings Association.

Table 4

No. of Loans	Int. Rate %	Orig. Term Yrs.	Average Inception Date	Remaining Loan Bal. as of 12/24/80	Market Value
1	7.5	25	8/30/72	\$ 26,393.86	\$ 17,101.75
2	8.0	20	7/30/73	22,227.65	15,945.98
1	8.25	20	7/30/73	8,714.76	6,334.47
1	8.5	25	5/31/76	17,739.61	11,728.76
2	8.5	25	2/29/77*	84,449.97	55,398.77
2	8.5	30	4/30/77	65,259.06	40,960.32
1	8.75	20	5/31/76	35,353.74	25,267.99
3	8.75	20	10/31/76	61,933.13	44,012.84
3	8.75	20	9/30/77	53,074.67	37,265.73
2	8.75	25	6/30/74	26,755.85	18,392.94
2	8.75	25	7/31/75	32,339.03	21,966.89
2	8.75	25	6/30/76	44,398.86	29,874.55
1	8.75	25	1/31/77	18,876.01	12,628.47
6	8.75	25	9/30/77	176,795.31	117,539.59
1	8.75	30	7/31/75	34,220.30	22,217.99
2	8.75	30	9/30/76	67,060.24	43,172.54
2	8.75	30	8/31/77	93,705.71	59,955.09
1	9.0	20	5/31/75	9,820.84	7,222.76
1	9.0	20	4/30/76	11,589.66	8,417.92
1	9.0	20	10/31/77	25,725.41	18,334.46
3	9.0	20	4/31/78	59,402.73	42,086.14
4	9.0	25	3/31/78	107,597.53	72,591.52
44				<u>\$1,083,429.93</u>	<u>\$728,417.47</u>
90% participations				<u>\$ 975,086.94</u>	<u>\$655,575.72</u>

Table 5 shows, by buyer, the aggregate remaining loan balances of the loans participations in which were transferred

* So indicated in the stipulated exhibit.

by petitioner, 90 percent of these aggregate balances, the amount the buyer paid to petitioner, and the relationship of the amount paid to the loan balance transferred.

Table 5

(1) Buyer	(2) Remaining Loan Bal. as of 12/31/80	(3) 90%	(4) Amount Paid to Petitioner	(5) Column (4) as % of Column (3)
Rosemont				
Sav. Assoc.	\$ 162,326.47	\$ 146,093.82	\$ 99,388.66	68.03
Civic				
Sav. Assoc.	1,083,429.93	975,086.94	655,575.72	67.23
First Fin.				
Sav. Assoc.	5,963,676.47	5,367,308.82	3,432,714.35	63.96
Kenwood S. & L. Assoc.	465,242.23	418,718.01	271,176.09	64.76
Totals	<u>\$7,674,675.10</u>	<u>\$6,907,207.59</u>	<u>\$4,458,854.82</u>	<u>64.55</u>

Each of the loan participation sale and trust agreements entered into by petitioner on December 31, 1980, states "Seller hereby sells and issues to buyer * * * a 90% participation ownership (subject to the terms and conditions of said Participation Agreement) in loans described in the list * * * attached hereto * * *." The subject loans were described in packages by interest rate, total term, and term to maturity. The packages which were subject to the agreements were matched under the criteria of FHLBB Memorandum R-49.

As a result of the December 31, 1980, transactions, petitioner was required to undertake additional administrative activity. Petitioner continued to service the loans in which it had sold the participations. Monthly reports of the transferred loan participations were prepared by each of the transferor institutions for each of the transferee institutions. In addition, payments on the participations were made monthly. Petitioner also had to record and maintain record relative to the payments on the participation packages received from petitioner's trading partners.

Petitioner and Associates considered it advantageous to sell 90-percent participation interests in the loans rather than selling the loans outright. Petitioner thus was able to maintain its

relationship with the obligors on the loans, since these obligors were not aware that participation interests in their loans had been transferred. In addition, petitioner was not required to transfer the records associated with the mortgages to the buyers of the participation interests.

In entering into the December 31, 1980, transactions, petitioner relied on its officers' knowledge of the trustworthiness of the individuals from petitioner's trading partners and the assumed increase in value of the collateral from the date of the loans. In selecting the loans for inclusion, petitioner and petitioner's trading partners did not investigate individual loan files, employment histories of the individual borrowers, or the underlying value of the real estate securing the individual loans. Only current, i.e., nondelinquent, loans were considered.

The participations sold and bought* by petitioner all were in loans that had different obligors, that were "conventional" loans secured by mortgages on single-family residential properties, and that were current as of December 31, 1980. The underlying security for each loan was different, in that each property had a different location. Most of the properties are inside the Cincinnati "beltway" (U.S. highway I-275).⁴ Most of the in-beltway properties where petitioner was the seller are east of downtown Cincinnati, while the in-beltway properties where petitioner was the buyer are more evenly distributed throughout the area. Some of the properties where petitioner was the buyer are as far north as Dayton, Ohio (about 55 miles from Cincinnati), and some are as far east as Jackson, Ohio (about 120 miles from Cincinnati). Of the properties where petitioner was the seller, some are as far north as Middletown, Ohio (about 35 miles from Cincinnati), and some are as far east as Batavia, Ohio (about 25 miles from Cincinnati).

* Portions of Indiana and Kentucky are inside the Cincinnati beltway, but all of the properties are in Ohio. See Memorandum R-49, item 10, *supra*.

Sales or purchases of participations, such as the 90-percent participations involved in this case, are customary; and loans that are sold or purchased are usually sold or purchased in a group by savings and loan institutions. Reciprocal sales of loans by savings institutions occurred before the December 31, 1980, transactions. Although diversification by geography and other factors may be reasons for reciprocal sales transactions generally, such factors were not considered in the December 31, 1980, transactions.

In the savings and loan industry, it is recognized that, generally, mortgage loans do not run to the completion of the terms of the loans. Petitioner made no attempt to determine, on a loan-by-loan basis or an aggregate basis, whether there was a difference between the prepayment potential or anticipated income stream of the loan participations received by petitioner and those transferred by petitioner on December 31, 1980. Actual collections did not achieve the equality anticipated at the time of the transfers.

Table 6 shows the actual payments that were made on account of the loan participations that petitioner sold and the loan participations that petitioner bought in the December 31, 1980, transactions.

Table 6

A. Payments on Participations that Petitioner Sold			
Year	Principal	Interest	Total
1980 (Dec.)	\$ 34,701.50	\$ 21,382.87	\$ 56,084.37
1981	257,800.81	555,555.62	813,356.43
1982	436,363.54	535,448.10	971,811.64
1983	535,229.54	488,253.91	1,023,483.45
1984	531,543.80	448,783.87	980,327.67
1985 (thru March 31)	118,122.04	99,045.58	217,167.62
Totals	<u>\$1,913,761.23</u>	<u>\$2,148,469.95</u>	<u>\$4,062,231.18</u>

B. Payments on Participations that Petitioner Bought

Year	Principal	Interest	Total
1980 (Dec.)	\$ 4,915.60	\$ 10,307.45	\$ 15,223.05
1981	340,987.22	551,244.92	892,232.14
1982	366,480.57	530,205.40	896,685.97
1983	545,186.08	483,669.37	1,028,855.45
1984	437,770.45	446,202.40	883,972.85
1985 (thru March 31)	46,956.78	106,916.30	153,873.08
Totals	<u>\$1,742,296.70</u>	<u>\$2,128,545.84</u>	<u>\$3,870,842.54</u>

Participation interests are less liquid than whole loans in the secondary market. That is, there is an active secondary market for mortgage loans but very little market for participation interests. As a result, after the December 31, 1980, transactions, petitioner and its trading partners all were in a less liquid position (except for their income tax refunds) than they had been before the December 31, 1980, transactions.

The December 31, 1980, transactions met the criteria of Memorandum R-49 of the FHLBB and qualified for nonrecognition of loss under RAP. Petitioner did not report under RAP any losses on the December 31, 1980, transactions.⁸

The December 31, 1980, transactions were between independent parties; the transactions were closed and completed; the transactions were bona fide. At the time of the transactions, petitioner and its trading partners anticipated that the income stream earned from the loan participations that were acquired would be substantially equal to the income stream earned from the loan participations that were sold. If this anticipated equality did not occur, absent misrepresentations, the party receiving less in actual collections had no recourse against the party receiving more.

⁸ In the notice of deficiency, respondent allowed bad debt loss deductions on some of the loans that petitioner had sold participations in, as part of the December 31, 1980, transactions. The computation of the loss claimed by petitioner on the reciprocal sales transactions is not in dispute.

Before the December 31, 1980, transactions, petitioner's loan portfolio had decreased in market value because of economic conditions general to the savings and loan industry. The losses claimed by petitioner accurately reflect the decrease in petitioner's assets from book value to market value.

The December 31, 1980, transactions were motivated solely by the desire of petitioner and its trading partners to recognize for tax purposes (but not for regulatory purposes) the losses in market values of the loan portfolios each institution owned before the December 31, 1980, transactions.

OPINION

Respondent contends that the December 31, 1980, transactions were exchanges, and not independent purchases and sales; that, in order for gain or loss to be recognized on these transactions, the gain or loss must be realized; that there was no realization of gain or loss under section 1001⁹ because the property that petitioner gave was not materially different from what petitioner received; and that petitioner's claimed losses lack substance and are not allowable under section 165(a) because the transfers were solely tax-motivated and resulted in no significant change in petitioner's economic position. Respondent concedes that petitioner's claimed losses on the sales of the loan participations would have been realized, recognized, and deductible but for petitioner's simultaneous acquisition of the loan participations, as shown in tables 1 and 2, *supra*.

Petitioner maintains that the December 31, 1980, transac-

⁹ Unless otherwise indicated, all section and subtitle references are to sections and subtitles of the Internal Revenue Code of 1954 as in effect for 1980. The instant case involves 1974 through 1979 because the December 31, 1980, transactions, if given their claimed tax effect, produce net operating losses that are properly carried back to each of the earlier years. Petitioner filed a claim for tentative refunds and the tentative refunds were paid. Thus, although the dispute before us affects petitioner's tax liabilities for each year in the 7-year period, the resolution of the dispute depends entirely on the treatment of the December 31, 1980, transactions.

tions were sales and not exchanges; that the nonrecognition provisions in section 1.1001-1(a), Income Tax Regs., are "inapplicable and . . . overridden by the other provisions in the Regulations and the Internal Revenue Code"; that even if the regulation applies, the mortgage loans with different obligors are not substantially similar and they differ materially in kind or extent; that the treatment of the December 31, 1980, transactions for purposes of GAAP and RAP has no effect on tax treatment; and that the transfers "were for a valid economic purpose".

We agree with respondent that the December 31, 1980, transactions were exchanges, and not independent purchases and sales; that these transactions were solely tax-motivated and had no business purpose other than to secure refunds of previously paid taxes by generating substantial net operating loss carrybacks; and that, in order for a gain or loss to be recognized, the gain or loss must be realized. We agree with petitioner that it realized the claimed losses on these transactions, that these losses are recognizable, and that these losses are deductible.

Sales v. Exchanges

As a preliminary matter, we reject petitioner's contentions that the four pairs of transactions occurring on December 31, 1980, were not reciprocal and cannot be regarded as "exchanges" as distinguishable from "sales". Petitioner argues that the loan sales transactions occurred between petitioner, on the one hand, and four other savings and loan institutions, on the other, solely as a matter of expediency. Petitioner denies that the transactions were reciprocal, interdependent, or conditioned on one another, and points out that the agreements do not expressly make them interdependent.

The obvious and expressed intention of the contracting parties was to come within the terms of Memorandum R-49. That Memorandum specifically referred to "reciprocal sales of substantially identical mortgage loans". The testimony at trial, including that of Kordis, referred to the transactions as reciprocal. Kordis testified that, but for the deposit of checks

from petitioner's trading partners in the December 31, 1980, transactions (see table 3, *supra*), petitioner "probably" would have had to borrow funds in order to be sure that its checks would be honored. Milostan further described the December 31, 1980, transactions as interdependent. Petitioner did not object to respondent's proposed finding, adopted by us *supra*, that Memorandum R-49 was the FHLBB's response to a desire of the savings and loan industry to structure exchanges of mortgage loans to create losses for income tax reporting purposes. Petitioner's counsel conceded, in his opening statement at trial, that petitioner bought about as much as it sold, "in order to comply with the regulatory accounting principle known as R-49, which required that loans be purchased in order not to recognize the loss [for] financial accounting purposes which, in most instances, if it had to be recognized, would have brought these savings and loans beneath the net worth requirements of the Federal Home Loan Bank." The only practical interpretation of the simultaneous purchases and sales were that they were interdependent in order to avoid the necessity of reporting losses under GAAP or RAP. Under these circumstances, the separate agreements will be regarded together as an overall transaction rather than as separate sales between the contracting parties. See *Johnson v. Commissioner*, 495 F.2d 1079, 1082 (CA6 1974), affg. 59 T.C. 791, 807-808 (1973); *Estate of Schneider v. Commissioner*, 88 T.C. 906, 938-942 (1987), on appeal (CA7, Oct. 6, 1987); *Monson v. Commissioner*, 79 T.C. 827, 834-837 (1982); *Smith v. Commissioner*, 78 T.C. 350, 380-381 (1982). Thus, we have adopted, for purposes of our opinion, respondent's characterization of the transactions as exchanges.

However, this conclusion does not resolve the case before us; it merely sets the framework for the remainder of our analysis. See *Monson v. Commissioner*, *supra*; *Smith v. Commissioner*, 78 TC. at 385-390.

Basic Analysis

Under section 1001,⁷ if there has been a sale or other disposition of property and the taxpayer's basis exceeds the amount realized, then the resulting loss is to be recognized unless subtitle A provides otherwise. Respondent does not contend that any nonrecognition provision in subtitle A applies to the transfers of the mortgage loan participations in dispute in the instant case (except to the extent that section 1001 may be viewed as a nonrecognition provision). Under section 165(a),⁸ the losses are deductible for 1980 (see n. 6, *supra*) if they were sustained during 1980.

On December 31, 1980, petitioner simultaneously bought and sold 90-percent participations in residential mortgage

⁷ Section 1001 provides, in pertinent part, as follows:

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) **Computation of Gain or Loss.** — The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section and for determining loss over the amount realized.

(b) **Amount realized.** — The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized —

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) **Recognition of Gain or Loss.** — Except as otherwise provided in this subtitle [subtitle A, relating to income taxes], the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

⁸ **SEC. 165. LOSSES.**

(a) **General Rule.** — There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

loans. The transfers were at then-current fair market values which, in the case of the participations that petitioner sold, were substantially below petitioner's cost bases. (See table 5, *supra*.) The loans that were affected were carefully selected by petitioner and by petitioner's trading partners to satisfy the equivalence criteria set forth in FHLBB Memorandum R-49, and also to match as nearly as practicable the aggregate fair market values of the loan participations transferred in the opposite direction. See tables 1, 2, and 3, *supra*. The transfers were bona fide, completed transactions. That is, petitioner assumed all the benefits and burdens of the loan participations it acquired and petitioner's trading partners assumed all the benefits and burdens of the loan participations they acquired from petitioner.

The transfers were solely tax-motivated. That is, although participations often are sold for a variety of business reasons, in the instant case the loan participation sales and offsetting purchases were effectuated solely to reduce petitioner's tax liabilities (and, presumably, the tax liabilities of petitioner's trading partners).⁹ This, by itself, is not fatal to petitioner's

⁹ Petitioner contends that there were other reasons, specifically geographic diversification, improving relations with other institutions, increasing its servicing portfolio, and the possibility of faster payoffs. The record would not support a finding that any of these possible concerns played any part in the transactions of December 31, 1980. In fact, the record supports a finding that they did not, and we have so found. Petitioner also states that "Milostan stated in his testimony that another reason to sell and repurchase loans was to reinvest the proceeds of the sale at prevailing market rates." However, table 3, *supra*, shows that almost 99.96 percent of petitioner's proceeds from the sale of participations were immediately used to buy participations from petitioner's trading partners. Table 6, *supra*, shows that petitioner's purchases resulted in a reduction in petitioner's cash flow. The only significant benefit petitioner received from the transactions was the tax loss deduction, which generated the net operating loss carrybacks, which in turn generated the tax refunds that led to the instant case (see n. 6, *supra*). Kordis testified that he was not aware of any benefits other than the tax refunds (and what petitioner could earn by investing the tax refunds) when petitioner decided to enter into the December 31, 1980, transactions. We conclude, and we have so found, that

claimed deduction in the context of the instant case (see, e.g., secs. 183(a) and 165(c)(2) for situations where this purpose might be conclusive)¹⁰, but it does require us to scrutinize the record with particular care. *Joseph E. Widener, Trust No. 5 v. Commissioner*, 80 T.C. 304, 310 (1983).¹¹

In *Widener*, stocks in different corporations were traded between two related trusts. The dispute was as to whether the relationship between the two trusts was such that the transactions "changed the flow of economic benefits from the stocks sold." 80 T.C. at 313. We held that they did, and allowed each trust to deduct its losses. In the instant case, the parties to the transactions are completely independent of each other. The dispute is as to whether the exchanged assets are suffi-

the generation of the tax loss deduction was the sole motive for the transactions in dispute.

¹⁰ We emphasize that we are not, in the instant opinion, limiting the effect of our statements in "shelter" opinions, "family trust" opinions, and other opinions regarding the effect of taxpayers' motives. In the instant case, the December 31, 1980, transactions were bona fide; they had nontax economic consequences (see table 6, *supra*). In the instant case, although the December 31, 1980, transactions were tax-motivated, they were merely the disposition of parts of assets that had previously been acquired by petitioner in the ordinary course of business in transactions entered into for profit. In the instant case, the taxpayers had already suffered economic losses which were unrealized for tax purposes until December 31, 1980; the December 31, 1980, transactions merely were realizations of these losses for tax purposes (see tables 4 and 5, *supra*).

¹¹ For example, we recognize that institutions wishing to engage in mortgage loan exchanges might consider understating fair market values in order to maximize their claimed current loss deductions. In the instant case, respondent's counsel stated at trial that he does not challenge the fair market values that petitioner and its trading partners asserted in the disputed transactions and, based on that concession and on the unchallenged evidence describing how the fair market values were determined, we have found that each of the transactions was at then-current fair market values. Under the circumstances, we deem inappropriate the implications of respondent's proposed finding of fact that "Petitioner's interest in valuing the mortgage participation packages exchanged was not adverse to the interest of the other savings and loan institutions * * *".

ciently different from each other to warrant treating petitioner's losses as having been realized.

The loan participations are not fungible, unlike cash (see *Owens v. Commissioner*, 568 F.2d 1233, 1240 (CA6, 1977), affg. on this issue 64 T.C. 1 (1975)), or shares of stock of the same class in a given corporation (see *McWilliams v. Commissioner*, 331 U.S. 694, 702 (1947)). The underlying securities and the obligors on the loans differed one from another. The claimed losses were the market economic losses that petitioner had in fact suffered as a result of changes in interest rates. Actual collections on these loan participations after December 31, 1980, the date of the transfers, did not achieve the equality anticipated at the time of the transfers. (See table 6, *supra*.) The transfers clearly did change the flow of economic benefits from the loan participations.

In addition, before the December 31, 1980, transactions petitioner owned real estate mortgage loans. After these transactions petitioner owned (1) real estate mortgage loans diminished by 90-percent participations and (2) 90-percent participations in other real estate mortgage loans. Ownership of participations in loans has a number of characteristics that differ from ownership of entire loans. (See our findings, *supra*, as to administrative advantages and burdens associated with loan participations (slip op. at 14-15) and diminished liquidity of loan participations (slip op. at 18).)

We conclude that petitioner realized and sustained the claimed losses in 1980, that petitioner is required to recognize these losses for 1980, and that petitioner is entitled to deduct these losses for 1980.

Realization and Recognition

Respondent contends that "The resolution of this case rests largely upon the application of Treas. Reg. § 1.1001-1(a)⁽¹²⁾

¹² Section 1.1001-1(a). Income Tax Regs., provides, in pertinent part, as follows:

Sec. 1.1001-1. Computation of gain or loss.

which limits the realization of gain or loss under section 1001 to transactions in which property is exchanged for 'other property differing materially either in kind or in extent' ".

The first sentence of this section of the regulation may be read as providing that income or loss is sustained if the income or loss is realized, and if this realization occurs from an "exchange of property for other property differing materially either in kind or in extent". The regulation could have, but does not state that this is the only way in which income or loss is sustained.¹³ However, respondent reads that sentence as

(a) *General rule.* Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001(a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (i.e., the cost or other basis adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. . . .

¹³ Respondent draws our attention to Treas. Regs. 45, Art. 1563 (1920 ed.), which interprets section 202 of the Revenue Act of 1918 (see sec. 1405 of the Act, 40 Stat. 1151), Pub. L. 65-254, 40 Stat. 1057, 1060. Art. 1563 provides, in pertinent part, as follows:

Art. 1563. Exchange of property. — Gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or into property (a) that is essentially different from the property disposed of, and (b) that has a market value. In other words, both (a) a change in substance and not merely

restricting "the occurrence or realization to situations where exchanged property differs materially in kind or extent." This appears to be equivalent to the converse of the language that is actually in the regulation.¹⁴

in form, and (b) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized. By way of illustration, if a man owning ten shares of listed stock exchanges his stock certificate for a voting trust certificate, no income is realized, because the conversion is merely in form; or if he exchanges his stock for stock in a small, closely held corporation, no income is realized if the new stock has no market value, although the conversion is more than formal; but if he exchanges his stock for a Liberty bond, income may be realized, because the conversion is into independent property having a market value.

We note that this regulation explicitly states that there cannot be realization unless there is "a change in substance", and implies that a change in substance can only come from a conversion "into cash or into property (a) that is essentially different from the property disposed of". The present regulation (n. 12, *supra*) omits any statement that there cannot be a realization unless there is a change in substance. Since respondent changed this part of the language of the regulation, one may reasonably infer that respondent intended to change the meaning of the regulation. See *Zuanich v. Commissioner*, 77 T.C. 428, 443 n. 26 (1981). Since the change in the language is to omit in the current regulation, the earlier regulation's relatively clear statement that realization requires an essential difference between the property acquired and the property disposed of, it may fairly be concluded that respondent has eliminated this essential-difference requirement.

¹⁴ For an illustration of the danger of assuming that converses are equivalents, see the following colloquy from "A Mad Tea-Party":

The Hatter opened his eyes very wide on hearing this; but all he said was "Why is a raven like a writing-desk?"

"Come, we shall have some fun now!" thought Alice. "I'm glad they've begun asking riddles — I believe I can guess that," she added aloud.

"Do you mean that your think you can find out the answer to it?" said the March Hare.

"Exactly so," said Alice.

"Then you should say what you mean," the March Hare went on.

"I do," Alice hastily replied; "at least — at least I mean what I say — that's the same thing, you know."

Our disagreement with respondent's conclusion does not rest on whether his regulation should be given the interpretation for which he contends. Rather, assuming that respondent is correct in his interpretation of his regulation, we conclude that the property petitioner acquired differs "materially . . . in kind" from the property petitioner transferred. We conclude, further, that the cases and concepts to which respondent directs our attention either are distinguishable or support petitioner's conclusion.

In support of respondent's interpretation of the regulation, respondent cites a series of cases, the best known of which is *Eisner v. Macomber*, 252 U.S. 189 (1920), in which courts have held that there was no taxable income from a transaction that left the stockholder with essentially the same position that the stockholder had in a corporation before the transaction in question. See *Towne v. Eisner*, 245 U.S. 418 (1918); *Weiss v. Stearn*, 265 U.S. 242 (1924).¹⁵

Respondent devotes a substantial portion of his brief to the history of predecessor statutes to section 1001, beginning with section II; B of the Tariff Act of 1913, Pub. L. 63-16, 38 Stat.

"Not the same thing a bit!" said the Hatter. "Why, you might just as well say that 'I see what I eat' is the same thing as 'I eat what I see!'"

"You might just as well say," added the March Hare, "that 'I like what I get' is the same thing as 'I get what I like!'"

"You might just as well say," added the Dormouse, which seemed to be talking in its sleep, "that 'I breathe when I sleep' is the same thing as 'I sleep when I breathe!'"

"It is the same thing with you," said the Hatter, and here the conversation dropped, and the party sat silent for a minute, while Alice thought over all she could remember about ravens and writing-desks, which wasn't much.

Dodgson, C.L., "The Complete Works of Lewis Carroll" (Alice's Adventures in Wonderland), pp. 75-76 (Modern Library ed.).

¹⁵ We may pass over the irony that respondent now relies on cases in which he had earnestly argued that taxpayers had realized gains — and should be currently taxed on them — even though the taxpayers had received only proportionate stock dividends. In the instant case, the shoe appears to be on the other foot.

114, 167.¹⁶ Various nonrecognition provisions begin in 1921 and continue through the Revenue Acts of 1926, 1928, 1932, 1936, and 1938, and in the Internal Revenue Codes of 1939 and 1954. Respondent summarizes his position as follows:

In limiting the realization of gains and losses to exchanges involving materially different property, Treas. Reg. § 1.1001-1(a) is a vestige of the prior regulations and early Revenue Acts and reflects a position that gain or loss arises upon a change in the substance, not merely in the form, of the taxpayer's property. In general, sections 165 and 1001 require that gain or loss be realized by a specific event involving either a conversion or exchange of property. The requirement embodied in Treas. Reg. § 1.1001-1(a) that a conversion or exchange take place before gain or loss is sustained implies that a material change in the taxpayer's property is necessary before a realization of gain or loss occurs under section 1001.

Respondent claims that his position is supported by *Shoenberg v. Commissioner*, 77 F.2d 446 (CA8 1935), affg. 30 B.T.A. 659 (1934), and *Horne v. Commissioner*, 5 T.C. 250 (1945).

In *Horne*, for the conceded purpose of establishing a tax loss (5 T.C. at 251), the taxpayer sold a certificate representing his membership (or "seat") in the New York Coffee and Sugar Exchange, Inc. Eight days before the sale, in order to assure uninterrupted membership in the exchange and in the use of the exchange's facilities, he bought another certificate

¹⁶ Section II; B of the Tariff Act of 1913 provides, in pertinent part, as follows:

B. That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from . . . sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from . . . dividends, . . . or gains or profits and income derived from any source whatever . . .

that differed from the first only by identifying number on the certificate. Respondent contended in *Horne* that the wash sales provision (sec. 118, I.R.C. 1939) applied. We rejected that argument (5 T.C. at 253-254). Nevertheless, we concluded that the claimed deduction must be disallowed, following and quoting extensively from *Shoenberg* and summarizing the latter case's teaching as follows (5 T.C. at 254):

Underlying all of the loss deduction provisions of the statute is the concept of a financial detriment actually suffered by the taxpayer. Before any deduction is allowable there must have occurred some transaction which when fully consummated left the taxpayer poorer in a material sense. That principle was thoroughly expounded by the court in *Shoenberg v. Commissioner* (C.C.A., 8th Cir.), 77 Fed. (2d) 446, affirming 30 B.T.A. 659; certiorari denied, 296 U.S. 586. There the taxpayer, for the purpose of establishing a tax loss, sold shares of stock through a broker at less than their cost and at the same time had the broker purchase a like number of the same shares for a wholly owned corporation. After the expiration of 30 days he then had the corporation transfer the shares back to him. In sustaining our disallowance of the loss deduction claimed the . . . [Court of Appeals] said:

Among the "transactions" or "identifiable events" which may operate to realize and fix a loss, the most commonly occurring is a sale of the property. Here there was an actual sale of these shares, and, if our examination must stop with that sale, this loss is conclusively shown. The questions here are whether we can consider the entire situation which comprehends this sale, the purchase by the Globe Investment Company and the sale by it to the taxpayer; and, if we can, the effect thereof upon the above loss as being a deductible loss.

In our penultimate paragraph in *Horne*, we stated as follows (5 T.C. at 255-256):

Putting aside other considerations, the persuasive fact is that after consummation of the plan which petitioner had put into operation eight days previously he stood in exactly the same position as before, except that he was out of pocket \$100, the difference between what he paid for his new certificate and what he received for his old one. One "seat" was exactly like another. As to how the \$100 should be treated for tax purposes we are not now required to decide. Petitioner never divested himself of the rights which he enjoyed by reason of his membership in the exchange, and never intended to do so. Although he went through the form of purchasing one certificate and selling another, the result was the same as if he had exchanged his certificate for that of another member. The deduction of a loss on such an exchange, that is, an exchange of property held for productive use in trade or business for property of a like kind to be held for such use, is expressly denied by section 112(b)(1) of the Internal Revenue Code [of 1939¹⁷].

In *Shoenberg*, the taxpayer, through his wholly owned corporation, was at all times in total control of shares of stock, indistinguishable from each other, and at the end of a short period of time was exactly where he started. In *Horne*, the taxpayer's position with respect to the asset, i.e., the exchange membership represented by both certificates, never change.

In the instant case, in contrast, petitioner exchanged participations in some loans for participations in other loans. Although the loans were similar, there were important differences. Specifically, the loans had different obligors and were secured by different pieces of realty. The subsequent history of payments on the loans (see table 6, *supra*) shows that the transactions were real, not feigned, and that the assets received were not the same as the assets given up. In the instant case (unlike *Shoenberg* and *Horne*), when the

¹⁷ In the instant case, respondent expressly concedes the inapplicability of sec. 1031, the successor to sec. 112(b)(1), I.R.C. 1939.

smoke cleared away petitioner was left with assets that were different (and performed differently) from what petitioner had at the start. Thus, application of the principle of *Horne* and *Shoenberg* to the December 31, 1980, transactions leads us to conclude that the property is materially different, and petitioner is entitled to the claimed deductions.

Both sides urge us to be guided by *Hanlin v. Commissioner*, 38 B.T.A. 811 (1938), *affd.* 108 F.2d 429 (CA3 1939). In *Hanlin* we applied the wash sales provision, section 118 of the Revenue Act of 1932,¹⁸ to three sets of transactions. We held that municipal bonds of the same obligor (Philadelphia) with insignificant differences in maturity dates were substantially identical securities. 38 B.T.A. at 813-818. We held that Federal Land Bank bonds of the same obligor (Omaha Federal Land Bank) with insignificant differences in maturity dates were substantially identical securities. 38 B.T.A. at 818-819.

However, we also held that bonds of the St. Louis and Wichita Federal Land Banks were not substantially identical to bonds of the Louisville Federal Land Bank. 38 B.T.A. 819-820. We rested our decision on the difference in obligors and the difference in assets underlying the promises of the different obligors. The Circuit Court of Appeals for the Third Circuit affirmed our conclusions as to all three sets of securities except that, with regard to the St. Louis, Wichita, and Louisville Federal Land Banks, the Circuit Court of Appeals focussed more on the differing underlying securities than on the differing obligors. 108 F.2d at 431.

In the instant case, the obligors are different and the underlying securities are different. The *Hanlin* standards lead us to conclude that the mortgage participations that petitioner acquired differ materially from the mortgage participations that petitioner transferred.

Respondent insists that the *Hanlin* criteria support his position in the instant case. He points out that the Circuit Court

¹⁸ In the instant case, respondent expressly concedes the inapplicability of sec. 1091, the successor to section 118 of the Revenue Act of 1932.

of Appeals in *Hanlin* focussed on the geographic differences between farmland near Wichita and farmland near Louisville, and directs our attention to the fact that "The geographical variations in risks of farm property which were critical to the decision in *Hanlin* are not present in this case, which involves residential real estate." Respondent overlooks the fact that *Hanlin* involved Federal Land Banks, each of which was at least secondarily liable on the debts of the others (108 F.2d at 431), while the instant case involves individual borrowers who apparently are each liable on only their own obligations. Respondent also overlooks the fact that, in *Hanlin*, each bond was secured by a mass of mortgages, so that only a regional disaster could affect the security of the bonds. Thus, in *Hanlin*, the courts focussed on regional differences. In the instant case, each obligation apparently is secured by one residential property, so that a misfortune affecting one family or one property could affect what happens to that obligation without affecting any of the other obligations. We conclude that petitioner's position in the instant case is stronger than the position that the taxpayer in *Hanlin* took with respect to the bonds of the St. Louis, Wichita, and Louisville Federal Land Banks.

Mass Assets

Respondent argues that because the mortgage loans were sold in packages, they should be treated and valued as "mass assets" (rather than individually) as were assets in *United Mercantile Agencies, Inc. v. Commissioner*, 23 T.C. 1105 (1955), modified as to other issues sub nom. *Drybrough v. Commissioner*, 238 F.2d 735 (CA6 1956), and similar cases in other contexts, including *Tomlinson v. Commissioner*, 58 T.C. 570 (1972), *affd.* 507 F.2d 723 (CA9 1974); *Marsh & McLennan, Inc. v. Commissioner*, 51 T.C. 58 (1968), *affd.* 420 F.2d 667 (CA3 1969); *Manhattan Co. of Virginia, Inc. v. Commissioner*, 50 T.C. 78 (1968); *Westinghouse Broadcasting Co. v. Commissioner*, 36 T.C. 912 (1961), *affd.* 309

F.2d 279 (CA3 1962); *Boe v. Commissioner*, 35 T.C. 720 (1961), affd. 307 F.2d 339 (CA9 1962).

Petitioner stresses the importance of the different underlying assets and different obligors.

In *United Mercantile*, the taxpayer bought a mixed aggregate of claims from the liquidators of four insolvent banks. We held as follows (23 T.C. at 1117):

In the instant case apportionment [of a purchase price among each of the claims purchased] would be wholly impractical. In each purchase United acquired hundreds of differing items, each having a highly speculative value if any value at all. Only years of attempting to collect on the various items would disclose which were worthless, the amount collectible on others, and whether the overall purchase would result in a gain or loss.

Respondent argues that as United's bid was influenced by whether the individual debtors were listed in the telephone books, by competitive bids which were made either on individual items or groups of individual items, and by information furnished by the liquidator concerning various items, there was a practical basis for allocation. We disagree. While this information was useful in determining an aggregate bid price, where the number of items involved would tend to balance out errors in estimates, it would not constitute a proper, rational, or reasonably accurate basis for allocating to each individual item a part of the cost. Under the circumstances, we think United properly recovered its cost before reporting a profit. *Webster Atwell*, 17 T.C. 1374 [1952] * * *; *Inaja Land Co., Ltd.*, [9 T.C. 727 (1947)] * * *; *William T. Piper*, [5 T.C. 1104 (1945)]; *John D. Fackler*, 39 B.T.A. 395 [1939].

In the instant case, each of the participations that petitioner sold had an easily determinable basis and sale price and each of the participations petitioner bought had an easily determinable cost. (See table 4, *supra*.) Consequently, if the ra-

tionale of *United Mercantile* is to be a guide to the instant case, then its guidance is that the factual setting of the instant case requires us to hold here for petitioner.

In *Tomlinson* and in *Marsh & McLennan*, we (and the respective Courts of Appeals) held that the insurance expirations and loss experience records could not give rise to amortization deductions or business loss deductions on the records in those cases because (1) these intangibles were too closely related to nondeductible and nonamortizable goodwill, (2) even if severable from goodwill, no useful life had been established for the intangibles, and (3) no separate bases had been established for the individual expirations. None of the factual elements that we (and the respective Courts of Appeals) held to be critical in *Tomlinson* and in *Marsh & McLennan* are present in the instant case. The *Tomlinson* and *Marsh & McLennan* criteria lead to a holding for petitioner in the instant case.

In *Manhattan Co.*, we held that it was possible to apportion the taxpayer's cost of the acquired intangibles between customer lists (75 percent) and goodwill (25 percent), and to determine the useful life of the customer lists with reasonable accuracy (5 years); we rejected the taxpayer's effort to allocate the cost among the separate customers. Although the result in *Manhattan Co.* is different from that in *Tomlinson* and in *Marsh & McLennan*, the criteria appear to be the same. Our conclusion in the instant case also is the same; those criteria lead to a holding for petitioner in the instant case.

In *Westinghouse* and in *Boe*, we held that the customer service contracts there involved could not give rise to amortization deductions because (1) no separate bases had been established for the individual contracts and (2) no useful life had been established for the mass of the contracts. The Court of Appeals in *Boe*¹⁸ agreed, but as an alternative concluded

¹⁸ This issue was not appealed in *Westinghouse Broadcasting Co. v. Commissioner*, 36 T.C. 912 (1961), affd. 309 F.2d 279 (CA3 1962), and the Court of Appeals did not comment on this issue.

that the taxpayers had not established any separation between the contracts and nonamortizable goodwill. The criteria of *Westinghouse* and *Boe* also lead to a holding for petitioner in the instant case.

Thus, respondent's mass asset theory does nothing to advance his contentions, and all the cases he cites support petitioner's position in the instant case.

As in *Smith v. Commissioner*, 78 T.C. at 385-389, respondent is asking us to create a nonstatutory wash sale doctrine.

Our problem in accepting respondent's position is analogous to that we faced in *Smith* dealing with the proper tax treatment of silver futures "straddle"²⁰ trading on the Commodity Exchange.

In *Smith*, we stated as follows (78 T.C. at 387-389):

Respondent's real, if obliquely articulated, objection, it seems to us, is that it is unfair to let petitioners recognize their losses because they knew ahead of time that there would likely be sufficient unrealized gain in their short July 1974 legs to borrow against so that they would not have to suffer any economic discomfiture on the switch. We might be more sympathetic with respondent's argument if in fact petitioners were guaranteed to have an exact offsetting unrealized gain available on August 9. However, here, they were not so assured. Contracts in different delivery months could, and in fact, did, show varying relative prices during the course of petitioners' straddles trades. While the actual pricing differences may have been small considering the size of petitioners' investments, we are not prepared to say such differences were de minimis. For us to draw a line, here, by saying that investments in these different assets must be integrated for tax purposes because their prices travel too much in tandem, simply begs the question: How

²⁰ In *Smith v. Commissioner*, 78 T.C. 350, 355 (1982), we defined a commodity straddle as simultaneous holding in a long position in one delivery month and a short position in another delivery month.

nearly parallel is too nearly parallel? If platinum and gold futures prices travel roughly in tandem, are we to integrate a straddle in opposing platinum and gold futures? If the prices of certain utility stocks travel in a parallel fashion, are we to integrate a long position in utility A stock with a short position in utility B stock? A little reflection shows that straddles may be maintained in almost anything.

The complexity of enunciating a theory defining which investments are too nearly parallel is demonstrated by section 1092, added to the Code by the Economic Recovery Tax Act of 1981, Pub. L. 97-34, sec. 501, 95 Stat. 323. Section 1092 sets up various rebuttable presumptions regarding what positions are "offsetting" for purposes of applying the new straddle provisions. Section 1092(c)(3)(A) states five statutorily defined factors which indicate a straddle in offsetting positions and authorizes the Secretary to promulgate regulations naming further factors (and thereby creating further rebuttable presumptions) which indicate offsetting positions. We do not believe it is within the province of this Court to attempt to draft our own novel straddle integration provision.

We conclude that in the instant case both a nonstatutory wash sale doctrine and the step transaction doctrine are inappropriate to achieve respondent's result. In the past, nonstatutory wash sale consequences have resulted in cases where a party has failed to completely relinquish an economic investment in the same or a substantially identical asset. *McWilliams v. Commissioner*, 331 U.S. 694 (1947); *Horne v. Commissioner*, 5 T.C. 250 (1945). In the instant case, after the switch, petitioners were not holding the same assets, March 1974 and December 1974 futures, but were instead holding May 1974 and September 1974 futures. These new positions were not substantially identical assets for purposes of the statutory wash sale provision (*Corn Products*

Refining Co. v. Commissioner, supra, 16 T.C. [395] at 399-400 [1951], *affd.* on this issue 215 F.2d [513] at 516-517 [(CA2 1954)], nor were they substantially identical for any other wash sale approach. *Harriss v. Commissioner, supra* [44 B.T.A. 999 (1941), *affd.* 143 F.2d 279 (CA2 1944)]; *Valley Waste Mills v. Page, supra* [115 F.2d 466 (CA5 1940)]. We fail to see how the mere simultaneous holding of a short July 1974 position throughout this period changes the result. Accordingly, a nonstatutory wash sale approach does not require the integration of petitioners' losses. [Fn. ref. omitted.²¹]

In the instant case, future collections on the loan participations sold could not be expected to coincide in dollar amount to collections on the participations purchased but would almost certainly exceed the fair market values of the loan portfolios as of December 31, 1980. As reflected in our findings, most loans do not run to their stated maturity dates. Bad debt losses occur. Discounting to the "present value" of future earnings, necessarily considered in determining fair market value, makes it likely that actual collections will exceed the new basis of loan portfolios obtained if the losses are recognized in these transactions. Petitioner would thereby achieve a present loss deduction and deferred gain recognition. This result alone, however, does not compel judicial preclusion. See, e.g., *Smith v. Commissioner*, 78 T.C. at 389.²² See also *Joseph E. Widener, Trust No. 5 v. Commissioner*, 80 T.C. at 310.

²¹ The parties in the instant case each presented expert witnesses who differed as to the significance of swapping individual residential loans or loan pools to the economic positions of the swapping institutions. The testimony exemplifies the numerous choices to be made in deciding whether a variable precludes or creates substantial identity or material difference.

²² Respondent relies on *Smith v. Commissioner*, 78 T.C. 350 (1982), in his analysis of the Sale v. Exchange dispute, discussed *supra*. We agree with his reliance on *Smith* for that aspect of the instant case. However, *Smith* is a sword with several edges. The edge which is relevant on the aspect of the case dealt with at this point in the opinion's text cuts against respondent.

RAP and GAAP

The parties have discussed the various pronouncements of the FHLBB and have presented expert testimony about what is or ought to be the required or permissible treatment of the December 31, 1980, transactions under GAAP.

The knowledgeable experts that the parties brought forth did "assist the trier of fact to understand the evidence or to determine a fact in issue", in accordance with Rule 702, Fed. R. Evid. However, it is unclear whether under GAAP petitioner must report losses on the December 31, 1980, transactions, or must not report losses on these transactions, or may elect to report or not as it wishes. It is also unclear as to what effect GAAP should have on tax reporting in the context of the instant case. See, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561, 577 (1978).

As to the effect of Memorandum R-49, we note that "it has been consistently held that the accounting requirements of regulatory agencies are not controlling in the application of the revenue laws, which establish their own standards." (Citations omitted.) *Bellefontaine Federal Savings & Loan Association v. Commissioner*, 33 T.C. 808, 811-812 (1960). As to the significance of a nontax agency's understanding of tax law, see *Graff v. Commissioner*, 74 T.C. 743 (1980), *affd.* 673 F.2d 784 (CA5 1982).

As a result of the foregoing, we have examined the requirements of section 1001 in the context of the tax laws and the tax precedents that the parties have relied on — the determinations of the FHLBB and the accounting profession have neither led us to, nor away from, the conclusions we have reached.

Section 165

Respondent's final contention is that petitioner is not entitled to a loss deduction under section 165(a). Respondent states as follows:

A transaction involving legally enforceable arrangements between legitimate entities may lack substance

and fail to achieve the desired tax effect because it is purposeless apart from tax motivations. *Gregory v. Helvering*, 293 U.S. 465 (1935); *Davis v. Commissioner*, 585 F.2d 807 (6th Cir. 1978) [affg. 66 T.C. 260 (1976)]; *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) [affg. 44 T.C. 284 (1965)].

In contrast to the cited cases, in the instant case—

(1) By December 31, 1980, petitioner had already suffered the real economic losses in transactions originally entered into for profit.

(2) On December 31, 1980, petitioner really did dispose of and acquire the loan participations; there were no limitations on the transfers that would cause petitioner to retain benefits or burdens on the loan participations it disposed of, or require shifting of benefits and burdens on the loan participations it acquired.

(3) The December 31, 1980, transactions were real transfers of real assets to and from unrelated parties.

We conclude that petitioner's realized, recognizable losses are deductible under section 165.

Respondent has drawn our attention to a recent opinion in *Centennial Savings Bank FSB v. United States* (N.D. Tex. Jan. 22, 1988), in which the taxpayer lost on a record apparently essentially similar to that in the instant case. In *Centennial*, the court concluded that the transactions there in dispute were exchanges and not merely sales (we have come to the same conclusion as to the December 31, 1980, transactions in the instant case), that the parties to the transactions there in dispute paid little or no attention to individual characteristics of the loans there involved (we have come to the same conclusion as to the December 31, 1980, transactions in the instant case), and that no loss was realized as a result of the transactions there in dispute.

We note that the *Centennial* opinion relies on *Schoenberg v. Commissioner*, *supra*, and *Eisner v. Macomber*, *supra*. In

Eisner v. Macomber, the taxpayer was held not to have income from proportionate stock dividends which left her in the same relationship to the corporation that she had been in before the distribution. In *Schoenberg*, we summarized the situation as follows (30 B.T.A. at 661):

At the start of the series of steps the taxpayer had a certain number of shares in various companies; at the close he had precisely the same number of shares in the same companies.

In the instant case, petitioner started with real estate mortgage loans; after the December 31, 1980, transactions petitioner had (1) those loans diminished by 90-percent participations and (2) 90-percent participations in other loans. The different groups of loans had different obligors, had different collateral, and performed differently. The instant case is significantly different from the cases relied on in the *Centennial* opinion.

The *Centennial* opinion stresses the taxpayer's compliance with Memorandum R-49 and concludes that "if Centennial claims the benefits of alleged business purposes for entering into the R-49 transaction, it must also bear the burdens. It cannot have its cake and eat it too." As we have pointed out, the requirements of RAP do not control the tax laws. We do not believe it is appropriate to judicially modify the tax laws in order to offset (or to enhance) the effects of benefits and burdens that may be dispensed by regulatory agencies. See *Bellefontaine Federal Savings & Loan Association v. Commissioner*, *supra*; *Graff v. Commissioner*, *supra*. We take the tax law as we find it.

We disagree with part of the analysis in *Centennial* and with the conclusion in *Centennial*.

We hold for petitioner. Because of a concession by petitioner (n. 1, *supra*),

Decision will be entered under Rule 155.

Reviewed by the Court.

STERRETT, PARKER, KÖRNER, SHIELDS, CLAPP, SWIFT, JACOBS, PARR, WELLS, and WHALEN, JJ., agree with the majority opinion.

GERBER and RUWE, JJ., did not participate in the consideration of this case.

COHEN, J., concurring: I concur in the result reached in this case and in *Federal National Mortgage Association v. Commissioner*, 90 T.C. ____ (filed today) (FNMA), that the taxpayers realized and may recognize losses on exchanges of interests in mortgage loan portfolios. I disagree with the result reached by the District Court in *Centennial Savings Bank FSB v. United States*, ____ F.Supp. ____, No. CA3-86-1396-H (filed January 22, 1988). The reason for my conclusion, however, differs from the analysis set forth in any of those opinions.

In this case and in FNMA, the Court finds that the loan portfolios that were the subject of the exchange transactions did differ materially, either in kind or extent, from each other. In *Centennial Savings Bank FSB*, the District Court concluded that the loan portfolios exchanged did not differ materially in kind or extent. It is possible, of course, to argue that these are merely permissible different conclusions reached by the respective trial judges, each of whom made findings of fact in support of his conclusion. It seems to me, however, that the correct result in these cases does not depend on such factual determinations.

My approach focuses on interpretation of section 1.1001-1(a), Income Tax Regs. As indicated in the majority opinion, that regulation could have, but does not state that income or loss is only sustained upon "exchange of property for other property differing materially either in kind or in extent" (page 29); prior regulations containing such a requirement have not been carried forward in the current regulation (footnote 13); and the converse of a true statement is not necessarily true (footnote 14). Respondent contends that the regulation means that the gain or loss realized from the ex-

change of property for other property *not* differing materially either in kind or extent is *not* treated as income or loss. I believe that the regulation deals with *computation* of gain or loss and not with whether gain or loss will be realized or recognized.

The regulation, of course, is subordinate to the statute. Section 1001(c) provides:

(c) Recognition of Gain or Loss.—Except as otherwise provided in this subtitle, the entire amount of gain or loss, determined under this section, on the sale or exchange of property shall be recognized.⁽¹⁾

The only relevant nonrecognition provisions or exceptions "otherwise provided in this subtitle" are the statutory wash sale provisions set forth in section 1031, dealing with like-kind exchanges, or section 1091, dealing with wash sales of stock or securities. The parties in this case (although not in FNMA or *Centennial*) agree that neither of those sections is applicable. Section 1031 expressly excludes applicability of the "like-kind exchange" rules to evidence of indebtedness. I suggest that this is an appropriate situation for applying the maxim "*Expressio unius est exclusio alterius*." See *duPont v. Commissioner*, 118 F.2d 544, 545 (3d Cir. 1941); 1 Mertens, *Law of Federal Income Taxation*, sec. 3.17.

¹ Section 1.1002-1(b), Income Tax Regs., promulgated under the predecessor of section 1001(c), states:

(b) *Strict construction of exceptions from general rule.* The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

As the majority points out, respondent is nonetheless asking that we adopt a nonstatutory wash sale provision. The majority correctly, in my view, rejects that position (pages 41-43). I would hold that, as a matter of law, there is no requirement applicable in this case that the properties exchanged differ materially in kind or in extent.

NIMS, WHITAKER, WRIGHT, and WILLIAMS, JJ., agree with this concurring opinion.

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 89-1036

COTTAGE SAVINGS ASSOCIATION,

Petitioner-Appellee,

v. —

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant.

Before: WELLFORD and NORRIS, Circuit Judges; and
LIVELY, Senior Circuit Judge.

JUDGMENT

(Filed December 4, 1989)

— ON APPEAL from a decision of the Tax Court of the United States.

THIS CAUSE came on to be heard on the transcript of record from the said tax court and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said tax court in this cause be and the same is hereby reversed and the petition for review is granted.

Each party is to bear its own costs on appeal.

ENTERED BY ORDER OF THE COURT
Leonard Green, Clerk

/s/ LEONARD GREEN
Clerk

Issued as Mandate: March 22, 1990.

[CERTIFICATION OMITTED]

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 89-1036

COTTAGE SAVINGS ASSOCIATION,
Petitioner-Appellee,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

ORDER

(Filed March 14, 1990)

BEFORE: WELLFORD and NORRIS, Circuit Judges; and
LIVELY, Senior Circuit Judge.

The Court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this Court, and less than a majority of the judges having favored the suggestion, the petition for rehearing has been referred to the original hearing panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT

/s/ LEONARD GREEN
Clerk

FEDERAL HOME LOAN BANK BOARD MEMORANDUM

R 49 LOSS NEED NOT BE RECORDED FROM 'RECIPROCAL SALES' OF SUBSTANTIALLY IDENTICAL MORTGAGE LOANS

June 27, 1980

The purpose of this memorandum is to advise OES staff on the proper accounting for reciprocal sales of mortgage loans.

A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:

1. involve single-family residential mortgages,
2. be of similar type (e.g., conventionals for conventionals),
3. have the same stated terms to maturity (e.g., 30 years),
4. have identical stated interest rates,
5. have similar seasoning (i.e., remaining terms to maturity),
6. have aggregate principal amounts within the lesser of 2½ or \$100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

When the aggregate principal amounts are not the same and the principal amount of the mortgage loans purchased is greater than the principal amount of the mortgage loans sold, the purchaser should record the additional principal. The difference between the additional principal and the additional cost should be recorded as a discount and amortized over a period of not less than ten years. If the principal amount of the mortgage loans purchased is less than the principal

amount of those originally sold, the purchaser should reduce its loan account. The difference between the reduction in loans and the amount of cash received should be charged to loss on sale of mortgage loans.

If a reciprocal sale does not meet all of the above criteria, the institution must record losses resulting from the sale.

No. 89-1965

Supreme Court, U.S.

FILED

JUL 19 1990

JOSEPH F. SPANIOLO
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1990

COTTAGE SAVINGS ASSOCIATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a substantially identical group of mortgage loans held by another financial institution.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Discussion	6
Conclusion	7

TABLE OF AUTHORITIES

Cases:

<i>San Antonio Savings Ass'n v. Commissioner</i> , 887 F.2d 577 (5th Cir. 1989), petition for cert. pend- ing, No. 89-1928	2, 6
--	------

Statutes:

Internal Revenue Code (26 U.S.C.):

§ 165	5
§ 1001	5

In the Supreme Court of the United States

OCTOBER TERM, 1990

No. 89-1965

COTTAGE SAVINGS ASSOCIATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT*

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-15a) is reported at 890 F.2d 848. The opinion of the Tax Court (Pet. App. 16a-56a) is reported at 90 T.C. 372.

JURISDICTION

The judgment of the court of appeals (Pet. App. 57a) was entered on December 4, 1989. A petition for rehearing was denied on March 14, 1990 (Pet. App. 58a). The petition for a writ of certiorari was filed on June 11, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a mutual savings and loan association formerly regulated by the Federal Home Loan Bank Board. In 1980, petitioner's mortgage loan portfolio was partially comprised of fixed-rate, long-term mortgage loans that had been issued previously at interest rates significantly lower than those charged on more recent loans. As a result of the high interest rates of the early 1980s, the fair market value of these older, low-interest loans fell far below their face amount. Pet. App. 2a, 18a.

For petitioner, like other savings institutions holding older, low-interest loans, this situation created a tax incentive for disposing of its depreciated mortgage loans. A disposition of the loans would enable petitioner to realize for tax purposes the loss that resulted from these market changes; it could then utilize the resulting loss deductions to offset current taxable income and produce loss carrybacks that would generate tax refunds from prior years. There was, however, a catch. Many of these institutions were in such precarious financial condition that a sale of the loans and consequent recognition of the losses—however beneficial for tax purposes—would for regulatory accounting purposes have caused them to fail to meet the Bank Board's minimum reserve and liquidity requirements, raising the prospect of closure by the Bank Board. See Pet. App. 18a-19a; *San Antonio Savings Ass'n v. Commissioner*, 887 F.2d 577, 579 (5th Cir. 1989), petition for cert. pending, No. 89-1928.

On June 27, 1980, the Bank Board's Office of Examination and Supervision (OES) issued Memorandum R-49, a regulatory accounting principle that adopted the rule that savings institutions could make "reciprocal sales" of depreciated "substantially identical mortgage loans" without having to record a loss for regulatory accounting purposes. Memorandum R-49 established a list of criteria that would

render loans "substantially identical," including that the mortgages be of similar type with the same terms and interest rates.¹ The admitted objective of Memorandum R-49 was to allow savings institutions to engage in transactions that would generate deductible losses for federal income tax purposes, but that would not be treated as giving rise to losses for financial reporting and regulatory purposes. Pet. App. 19a-20a.²

2. On December 31, 1980, petitioner entered into four separate transactions with four other savings institutions designed to exchange interests in mortgages that satisfied

¹ Memorandum R-49 specifically provided in part (Pet. App. 19a-20a):

A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:

1. involve single-family residential mortgages,
2. be of similar type (e.g., conventionals for conventionals),
3. have the same stated terms to maturity (e.g., 30 years),
4. have identical stated interest rates,
5. have similar seasoning (i.e., remaining terms to maturity),
6. have aggregate principal amounts within the lesser of 2 1/2% or \$100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

² A memorandum from the Director of OES to an officer of the Bank Board described the "objective" of Memorandum R-49 as "to structure a transaction which was as close as possible to the IRS 'materially different' definition which would still not change the economic position of the association after it engaged in the swap." Pet. App. 21a.

the requirements of Memorandum R-49. In each transaction, petitioner effectively exchanged a package of 90% participation interests in a group of mortgage loans for a package of 90% participation interests in a group of mortgage loans held by the other institution. Pet. App. 24a-27a, 32a-33a.³ In each transaction, the participation interests exchanged were in loan packages having almost identical face and market value (*id.* at 25a), and the loans involved were "substantially identical" according to the criteria set forth in Memorandum R-49 (*id.* at 30a). In selecting loans to be exchanged, petitioner and its trading partners did not investigate the credit ratings of any of the borrowers on the loans it received and did not investigate the value of the real estate that secured the loans. *Id.* at 4a, 28a. The pricing or valuation of all the loans was established by using one common discount factor based on the then-current interest rate of 14.863%. *Id.* at 3a, 25a.

Each transaction was consummated in the form of a "reciprocal sale" by conveyance of the 90% participation interests together with a simultaneous transfer of checks by both parties in the amount of the fair market value of the interests acquired (Pet. App. 3a, 24a-25a). Petitioner paid a total of \$4,456,912 and received a total of \$4,458,855 in the four transactions (*id.* at 25a). The participation interests that it transferred had a face value of \$6,907,208 (*id.* at 27a). On its 1980 federal income tax return, petitioner claimed a deduction for a loss on the transaction in the amount of the difference between the face value of the participation interests transferred and the amount received for them. Pursuant to Memorandum R-49, petitioner did not report any loss for financial and regulatory accounting purposes. *Id.* at 2a, 30a.

³ Transactions designed to take advantage of Memorandum R-49 often involved exchanges of 90% participation interests, rather than the entire loan, so that the original mortgagee could maintain its relationship with the obligor on the loans. Pet. App. 27a-28a.

3. On audit, the Commissioner determined that petitioner was not entitled to its claimed deduction for a loss on the mortgage exchange transactions. Petitioner sought redetermination of the resulting income tax deficiencies in the Tax Court. After a trial, the Tax Court held for petitioner (Pet. App. 16a-54a).

The Commissioner's primary argument was that a loss is "realized" for tax purposes under Section 1001 of the Internal Revenue Code (26 U.S.C.) or in exchange of property only if the exchanged properties are "materially different" and that mortgages that were "substantially identical" under the Memorandum R-49 criteria were not materially different. The Tax Court concluded that the loans taxpayer transferred were "materially different" from the loans it received because the loans had different borrowers and were secured by different collateral (Pet. App. 40a-45a). The Tax Court also rejected the Commissioner's argument that, because the mortgage exchange lacked economic substance, deduction of the loss was not authorized by Section 165 of the Internal Revenue Code (*id.* at 51a-53a).

4. The court of appeals reversed (Pet. App. 1a-15a). The court agreed with petitioner's position that a loss was "technically realized" (*id.* at 10a) on an R-49 exchange of mortgages because, in the court's view, Section 1001 of the Code does not require that exchanged properties be "materially different" in order for an exchange to constitute a realization event (*id.* at 9a-10a). The court held, however, that because the exchange of mortgages pursuant to Memorandum R-49 did not result in any real change in petitioner's economic position, petitioner had not "sustained" a loss on the transactions that would permit it to take a loss deduction under Section 165 of the Code (Pet. App. 10a-15a). In particular, the court stated that loss deductions are not allowed on "transactions in which the taxpayer's economic position was not changed for the worse"

(*id.* at 12a-13a), and it concluded that petitioner's "economic position was not changed" by an exchange of a pool of mortgages for "a substantially identical pool of mortgages" (*id.* at 14a).

DISCUSSION

This case presents the same question that is presented in three petitions pending from decisions of the Fifth Circuit (*United States v. Centennial Savings Bank (Resolution Trust Corporation, Receiver)*, No. 89-1926 (Question 1); *United States v. First Federal Savings and Loan Ass'n*, No. 89-1927; *Commissioner v. San Antonio Savings Ass'n and Subsidiaries (Resolution Trust Corporation, Receiver)*, No. 89-1928), and in a petition pending from a decision of the District of Columbia Circuit (*Commissioner v. Federal National Mortgage Ass'n*, No. 89-1987) — namely, whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a "substantially identical" group of mortgage loans. As we explain in detail in our petition in *Centennial*, review of this question by this Court is warranted because there exists a square conflict in the circuits between the decision below and the decisions of the Fifth and District of Columbia Circuits (see *Centennial* Pet. 11-13) and the issue is of considerable importance to the administration of the federal tax laws.⁴ We have accordingly urged that the Court grant plenary review in *Centennial* and in *First Federal* (see *Centennial* Pet. 13 n.10). Because the question presented here is the same as that already presented in *First Federal* and in *Centennial*, we believe that there is no need for the Court to grant plenary review in this case as well but that

⁴ We are supplying petitioner's counsel with copies of our petitions in *Centennial*, *First Federal*, *San Antonio*, and *Federal National Mortgage Ass'n*.

it would be appropriate for the Court to hold this case pending the outcome in *Centennial* and *First Federal*.

CONCLUSION

The petition for a writ of certiorari should be disposed of as appropriate in light of this Court's disposition of *United States v. Centennial Savings Bank (Resolution Trust Corporation, Receiver)*, No. 89-1926, and *United States v. First Federal Savings & Loan Ass'n*, No. 89-1927.

Respectfully submitted.

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JULY 1990

* The Solicitor General is disqualified in this case.

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No. 89-1965

Supreme Court, U.S.
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In The
Supreme Court of the United States
October Term, 1990

COTTAGE SAVINGS ASSOCIATION,
Petitioner,
v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ Of Certiorari To The
United States Court Of Appeals For The
Sixth Circuit

BRIEF FOR PETITIONER

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QUESTION PRESENTED FOR REVIEW

- I. Whether a savings institution, having incurred real economic losses on residential mortgages it holds, realizes and recognizes a deductible loss for income tax purposes when it exchanges its mortgages for mortgages of another savings institution that (i) have different obligors, (ii) are secured by different real properties, and (iii) perform differently in terms of actual payments received.

RULE 29.1 STATEMENT

Pursuant to Rule 29.1 of the Rules of this Court, Petitioner, Cottage Savings Association, states that Tri-State Bancorp is its parent company and that it has no subsidiaries other than wholly owned subsidiaries.

TABLE OF CONTENTS

	Page
OPINIONS BELOW.....	1
JURISDICTION.....	2
RELEVANT STATUTORY PROVISIONS.....	2
STATEMENT OF THE CASE.....	3
SUMMARY OF THE ARGUMENT	8
ARGUMENT	13
I. SECTION 165 OF THE CODE DOES NOT PRECLUDE THE DEDUCTION OF THE LOSS REALIZED AND RECOGNIZED BY COTTAGE	13
A. COTTAGE PROPERLY DEDUCTED ITS LOSS BECAUSE THE LOSS WAS REALIZED, RECOGNIZED AND ALLOWED AS A DEDUCTION UNDER SECTIONS 1001 AND 165 OF THE CODE	13
B. ALL REALIZED LOSSES FROM SALES OR EXCHANGES OF PROPERTY ARE "SUSTAINED" UNDER SECTION 165 ...	15
C. THE SIXTH CIRCUIT'S TEST FOR WHEN A LOSS IS SUSTAINED IS CONTRARY TO PRECEDENT	16
D. THE SIXTH CIRCUIT'S DECISION IS UNSUPPORTED BY THE AUTHORITIES UPON WHICH IT RELIES.....	20
E. THE SIXTH CIRCUIT'S DECISION ATTEMPTS TO CREATE A NON-STATUTORY WASH-SALE RULE	23
F. SECTION 165 DOES NOT PREVENT DEDUCTION OF COTTAGE'S LOSS.....	24

TABLE OF CONTENTS - Continued

Page

II. COTTAGE'S TRANSFER OF MORTGAGES RESULTED IN A REALIZED LOSS, AS A MATTER OF LAW, REGARDLESS OF WHETHER THE MORTGAGES COTTAGE RECEIVED DIFFERED MATERIALLY FROM THE MORTGAGES COTTAGE TRANSFERRED.....	26
A. THERE IS NO "MATERIALLY DIFFERENT" REQUIREMENT; SECTION 1001 REQUIRES THE RECOGNITION OF GAIN OR LOSS ON ALL EXCHANGES UNLESS A STATUTORY EXCEPTION APPLIES.....	26
1. Sections 1001(a) and (b) merely set forth the manner of computing the amount realized on a transaction, and do not create a statutory standard for realization.....	27
2. Section 1001(c) provides a general rule that, except as otherwise provided in the Code, all gain or loss is recognized from all exchanges.....	28
3. A 1920 Regulation does not establish a "materially different" standard under Section 1001.....	30
4. The legislative history of the statutory exceptions to recognition explicitly acknowledges that loss is realized and recognized on exchanges of notes, without regard to a materially different standard.....	32

TABLE OF CONTENTS - Continued

Page

B. THE "REALIZATION TEST" IS SIMPLE: IF THERE HAS BEEN A CHANGE IN THE VALUE OF PROPERTY, THEN GAIN OR LOSS IS REALIZED FOR TAX PURPOSES WHEN A SALE OR OTHER DISPOSITION OF THE PROPERTY OCCURS.....	34
1. <i>Eisner v. Macomber</i> established that a mere increase or decrease in the value of a taxpayer's asset does not constitute income or loss.....	35
2. Subsequent judicial authority established that the realization of income or loss can be triggered by either a disposition of the taxpayer's property or by an exchange for a different interest in the same property.....	38
C. JUDGE COHEN'S CONCURRING OPINION IN THE TAX COURT, THAT THERE IS NO MATERIALLY DIFFERENT REQUIREMENT, IS LEGALLY CORRECT.....	40
D. ADOPTION OF THE GOVERNMENT'S THEORY WOULD CREATE AN ADMINISTRATIVE NIGHTMARE.....	42
III. EVEN IF A "MATERIALLY DIFFERENT" STANDARD DID APPLY TO THE TRANSACTIONS AT ISSUE, THE TAX COURT WAS CORRECT IN CONCLUDING THAT THE MORTGAGES COTTAGE RECEIVED WERE MATERIALLY DIFFERENT FROM THE MORTGAGES COTTAGE TRANSFERRED AND COTTAGE'S LOSS SHOULD BE REALIZED AND RECOGNIZED.....	43
A. SIMILARITY OF RISKS AND ECONOMIC SIMILARITY HAVE NO APPLICATION IN TAX LAW.....	43

TABLE OF CONTENTS - Continued

	Page
B. THE HANLIN CASE REQUIRES THAT THIS COURT AFFIRM THE TAX COURT'S DECISION THAT THE MORTGAGE LOANS COTTAGE TRANSFERRED WERE "MATERIALLY DIFFERENT" FROM THE MORTGAGE LOANS IT RECEIVED AND THUS ITS LOSS SHOULD BE REALIZED AND RECOGNIZED.....	47
CONCLUSION	50
APPENDIX.....	1a

TABLE OF AUTHORITIES

	Page
CASES	
<i>Arkansas Best Corp. v. Commissioner</i> , 485 U.S. 212 (1988)	33
<i>Bellefontaine Federal Savs. & Loan Ass'n. v. Commissioner</i> , 33 T.C. 808 (1960)	19
<i>Centennial Savs. Bank FSB v. United States</i> , 887 F.2d 595 (5th Cir. 1989), <i>aff'g in part and rev'g in part</i> , 682 F. Supp. 1389 (N.D. Tex. 1988), <i>cert. granted</i> , 59 U.S.L.W. 3243 (U.S. Oct. 1, 1990) (No. 89-1926)	14, 18, 35, 37, 42
<i>Commissioner v. Brown</i> , 380 U.S. 563 (1965)	37, 43
<i>Davis v. Commissioner</i> , 585 F.2d 807 (6th Cir. 1978), <i>cert. denied</i> , 440 U.S. 981 (1979)	21
<i>Eisner v. Macomber</i> , 252 U.S. 189 (1920)	35, 36, 37
<i>Emery v. Commissioner</i> , 166 F.2d 27 (2d Cir. 1948)	40
<i>Federal Nat'l Mortgage Ass'n v. Commissioner</i> , 896 F.2d 580 (D.C. Cir. 1990), <i>aff'g</i> 90 T.C. 405 (1988)	8, 15, 25, 43
<i>First Fed. Savs. & Loan Ass'n of Temple v. United States</i> , 887 F.2d 593 (5th Cir. 1989), <i>aff'g</i> 694 F. Supp. 230 (W.D. Tex. 1988)	<i>passim</i>
<i>Ford Motor Credit Co. v. Milhollin</i> , 444 U.S. 555 (1980)	19
<i>Hanlin v. Commissioner</i> , 108 F.2d 429 (3d Cir. 1939), <i>aff'g</i> 38 B.T.A. 811 (1938)	<i>passim</i>
<i>Helvering v. Gregory</i> , 69 F.2d 809 (2d Cir. 1934), <i>aff'd</i> 293 U.S. 465 (1935)	9, 25
<i>Horne v. Commissioner</i> , 5 T.C. 250 (1945)	20, 21

TABLE OF AUTHORITIES – Continued

Page

<i>International Trading Co. v. Commissioner</i> , 484 F.2d 707 (7th Cir. 1973), <i>rev'g</i> 57 T.C. 455 (1971)	24
<i>Keats v. United States</i> , 865 F.2d 86 (6th Cir. 1988)	21
<i>Marr v. United States</i> , 268 U.S. 536 (1925).....	11, 39, 44, 45
<i>Owens v. Commissioner</i> , 568 F.2d 1233 (6th Cir. 1977).....	22
<i>Perlin v. Commissioner</i> , 86 T.C. 388 (1986).....	21
<i>San Antonio Savs. Ass'n v. Commissioner</i> , 887 F.2d 577 (5th Cir. 1989), <i>aff'g</i> 55 T.C.M. (CCH) 813 (1988)	<i>passim</i>
<i>Shoenberg v. Commissioner</i> , 77 F.2d 446 (8th Cir. 1935), <i>cert. denied</i> , 296 U.S. 586 (1935).....	9, 20, 21
<i>Sullivan v. United States</i> , 618 F.2d 1001 (3rd Cir. 1980).....	25
<i>Terry v. United States</i> , 10 F. Supp. 183 (D. Conn. 1934).....	22
<i>Thor Power Tool Co. v. Commissioner</i> , 439 U.S. 522 (1979)	9, 20
<i>Weiss v. Stearn</i> , 265 U.S. 242 (1924).....	11, 38, 39, 44
<i>Widener, Trust No. 5 v. Commissioner</i> , 80 T.C. 304 (1983), <i>acq.</i> 1984-2 C.B. 2	22, 23

TABLE OF AUTHORITIES – Continued

Page

STATUTES:

Internal Revenue Code of 1954 (26 U.S.C.)

26 U.S.C. § 56(g)(4)(E)	9, 24
26 U.S.C. § 165	<i>passim</i>
26 U.S.C. § 165(a)	2, 13
26 U.S.C. § 165(c)	2, 24
26 U.S.C. § 354	29
26 U.S.C. § 1001	<i>passim</i>
26 U.S.C. § 1001(a)	<i>passim</i>
26 U.S.C. § 1001(b)	<i>passim</i>
26 U.S.C. § 1001(c)	<i>passim</i>
26 U.S.C. § 1031	21, 29, 33, 41, 42
26 U.S.C. § 1031(a)	2, 32, 33
26 U.S.C. § 1036	29
26 U.S.C. § 1091	<i>passim</i>
<i>Revenue Act of 1918, Pub. L. No. 65-254 40 Stat. 1057 (1919)</i> § 202(b)	2, 30, 31
<i>Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 227</i> § 202(c)	2, 28, 32
§ 202(c)(1)	32

TABLE OF AUTHORITIES - Continued

Page

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§ 202(c) 2, 11, 32

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§ 202 2, 10, 27, 28

§ 203 *passim*

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§ 118 20

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§ 112(b)(1) 3, 21, 33

REGULATIONS

Treasury Regulations Under 1954 Code (26 C.F.R.)

26 C.F.R. § 1.165-1(b) 2, 8, 24, 25

26 C.F.R. § 1.165-1(d) 2, 8, 24

26 C.F.R. § 1.1001-1(a) *passim*

26 C.F.R. § 1.1002-1(a) 2, 11

26 C.F.R. § 1.1002-1(b) 2, 11, 29, 42

Treasury Regulations Under 1918 Act

Treas. Reg. § 45, art. 1563 (1920) 3, 11, 30, 31

TABLE OF AUTHORITIES - Continued

Page

MISCELLANEOUS

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H.R. Rep. No. 1432, 67th Cong., 4th Sess. 1-2
(1923) 32

H.R. Rep. No. 179, 68th Cong., 1st Sess. 12 (1924) .. 10, 27

H.R. Rep. No. 179, 68th Cong., 1st Sess. 13 (1924) 28

H.R. Rep. No. 1, 69th Cong., 1st Sess. 5 (1926) 27

H.R. Rep. No. 704, 73d Cong., 2d Sess. 13 (1934) .11, 33

S. Rep. No. 275, 67th Cong., 1st Sess. 11 (1921) 31

S. Rep. No. 398, 68th Cong., 1st Sess. 13 (1924) ..10, 27

S. Rep. No. 398, 68th Cong., 1st Sess. 14 (1924) ..10, 28

No. 89-1965

In The
Supreme Court of the United States
October Term, 1990

COTTAGE SAVINGS ASSOCIATION,
Petitioner,
v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ Of Certiorari To The
United States Court Of Appeals For The
Sixth Circuit

BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Sixth Circuit (P.A. 1a)¹ is reported at 890 F.2d 848. The opinion of the United States Tax Court (P.A. 16a) is reported at 90 T.C. 372.

¹ References to P.A. refer to the Appendix in the Petition for a Writ of Certiorari in this case. The filing of a Joint Appendix was dispensed with pursuant to a motion filed by Petitioner on October 25, 1990 and granted on November 5, 1990.

JURISDICTION

The judgment of the United States Court of Appeals for the Sixth Circuit was entered on December 4, 1989. A Petition for Rehearing was timely filed by the Petitioner on December 29, 1989. The Petition for Rehearing was denied on March 14, 1990. The Petition for Writ of Certiorari was filed on June 11, 1990. This Court granted the Petition on October 1, 1990. The Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

RELEVANT STATUTORY PROVISIONS

The following sections of the Internal Revenue Code of 1954 (26 U.S.C.) and Treasury Regulations on Income Tax (26 C.F.R.), sections of prior revenue acts and Treasury Regulations as well as Memorandum R-49 are set out verbatim in the Appendix or in the Petition for Writ of Certiorari as follows:

<i>Statutes and Regulations</i>	<i>Page</i>
<i>Internal Revenue Code of 1954</i>	-
Section 165(a)-(c)	1a
Section 1001(a)-(c)	1a
Section 1031(a)	2a
Treas. Reg. § 1.165-1(b) & (d)	2a
Treas. Reg. § 1.1001-1(a)	3a
Treas. Reg. § 1.1002-1(a)-(d)	4a
<i>Prior Revenue Acts</i>	
Section 202(b) Revenue Act of 1918	6a
Section 202(c) Revenue Act of 1921	6a
Section 202(c) Revenue Act of March 4, 1923	7a
Section 202 Revenue Act of 1924	7a
Section 203 Revenue Act of 1924	8a

Section 112(a) & (b)(1)	
Revenue Act of 1934	9a
Treas Reg. § 45, Art. 1563 (1920)	9a

Miscellaneous

Federal Home Loan Bank Bd. Mem. No. R-49 (June 27, 1980)	P.A. 59a
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STATEMENT OF THE CASE

Cottage Savings Association (hereinafter referred to as "Cottage") is a federally insured savings and loan institution subject to the regulations of the Federal Home Loan Bank Board (hereinafter sometimes referred to as the "FHLBB"). (P.A. 18a). On December 31, 1980, Cottage exchanged some of its mortgage loans for mortgage loans owned by four unrelated savings and loan institutions located in the Cincinnati and Portsmouth, Ohio areas. (P.A. 24a, 25a). Cottage's loan portfolio in general and the specific mortgage loans exchanged had declined in value because of economic conditions general to the savings and loan industry and because of increases in mortgage interest rates. (P.A. 25a, 31a). As a result of these transactions, Cottage deducted losses on its tax return for 1980, carried back said losses to earlier years (1974 through 1979), and recovered federal income taxes it had previously paid.

The Internal Revenue Service (sometimes hereinafter referred to as the "Government"), disagreeing with Cottage's tax treatment of this transaction (hereinafter sometimes referred to as "reciprocal mortgage loan transactions" or "reciprocal sales"), issued a statutory notice of deficiency to Cottage on June 24, 1983, disallowing the deductions. Cottage filed a petition in the United States Tax Court on September 23, 1983. A trial was held on June 18, 19 and 20, 1985 in Cincinnati.

On March 14, 1988, the Tax Court issued its opinion, reviewed by the entire court (two judges did not participate), holding for Cottage and sustaining Cottage's loss on its reciprocal mortgage loan transactions. (P.A. 16a). The Tax Court held that Cottage realized losses in the years under review and that the losses were recognized and deductible for income tax purposes. A decision was entered by the Tax Court on October 3, 1988.

From that judgment, the Internal Revenue Service took its appeal to the United States Court of Appeals for the Sixth Circuit by Notice of Appeal filed on December 30, 1988. After briefing and argument, the Court of Appeals rendered its opinion (P.A. 1a) and judgment (P.A. 57a) on December 4, 1989, reversing the judgment of the Tax Court.

The Court of Appeals agreed with the Tax Court that, in form, Cottage's reciprocal sales produced an identifiable event that fixed a loss which was both realized and recognized for federal income tax purposes. However, it reversed because it said that no loss was sustained by Cottage under Section 165 of the Internal Revenue Code.² A timely Petition for Rehearing was denied on March 14, 1990. (P.A. 58a).

The basic facts in this case are fully set forth in detail in the Sixth Circuit Court of Appeals (P.A. 1a) and Tax Court (P.A. 16a) opinions. As interest rates rose in the late 1970s, savings institutions were caught in a cash squeeze. Money was flowing into higher-yielding money market funds rather than to savings institutions as deposits. Even though their return from loans was low, the market required savings institutions to pay higher and higher interest rates in order to attract new deposits. Earnings declined as interest paid on deposits exceeded the

² Section 165 of the Internal Revenue Code provides, in general, that all losses sustained in a taxable year are deductible unless compensated by insurance or otherwise.

interest earned on long-term fixed-rate mortgage loan portfolios. (P.A. 2a, 18a).

Because of the increase in mortgage interest rates, the market values of existing fixed-rate mortgage loan portfolios held by savings institutions, including Cottage, were substantially less than the book values of these portfolios. Even though Cottage began offering adjustable rate mortgages in 1980, it continued to experience a drop in new loans and a drop in deposits. Cottage experienced a shortage of funds because of the loss of deposits to money market mutual funds and because the high interest rates charged by the FHLBB eliminated the FHLBB as a source of funds. Cottage expected this decline in deposits to continue. (P.A. 2a, 18a).

FHLBB regulations required Cottage (and other federally insured savings and loan institutions) to meet certain net worth requirements. If Cottage had merely sold the mortgage loans it transferred, and had been required by the FHLBB's regulatory accounting principles (sometimes hereinafter referred to as "RAP") to reduce its net worth by the amount of losses it would have sustained on such a sale, Cottage's net worth would have been reduced to a level that barely exceeded the FHLBB's minimum requirement. (P.A. 19a).

To relieve this dilemma, on June 27, 1980, the Director of the Office of Examination and Supervision ("OES") of the FHLBB promulgated a change in its accounting requirements known as "Memorandum R-49" ("R-49").³ Under R-49, institutions were no longer required to record such losses from the sale (and purchase) of mortgage loans on their books. By observing R-49's criteria, savings institutions including Cottage attempted to generate federal income tax refunds by entering into reciprocal sales transactions that produced deductible losses

³ Federal Home Loan Bank Bd. Mem. No. R-49 (June 27, 1980). The entire text of Memorandum R-49 is set forth in the Appendix to the Petition for Writ of Certiorari. (P.A. 59a).

without impairing their net worth. (P.A. 2a). R-49 lists ten criteria, all of which must be satisfied, for mortgage loans involved in reciprocal sales to be considered "substantially identical" for regulatory accounting principles. (P.A. 3a). Memorandum R-49 was the FHLBB's response to a desire of the savings and loan industry to structure exchanges of mortgage loans to create losses for income tax purposes which would not be reported for RAP or under generally accepted accounting principles. (P.A. 20a). All of the mortgage loans involved in Cottage's reciprocal sales satisfied the R-49 requirements. (P.A. 3a, 30a).

The ten criteria selected in R-49 represented an attempt by the FHLBB, OES to maintain the institution's position with respect to three types of risk in a loan portfolio: (1) credit (or collectability), (2) rate (or future earnings potential), and (3) repayment (or extent of principal repayments and prepayments). It was the OES' opinion that a change in any of these risks would change the economic factors underlying an institution's loan portfolio and require recording of the resulting gain or loss under RAP. (P.A. 21a). According to the OES, these ten criteria vary in importance and effect and all are necessary to structure a transaction that does not trigger a loss for accounting purposes. (P.A. 22a).

In October of 1980, Cottage's accountant attended a seminar where he was introduced to the concept of reciprocal loan sales. On November 6, 1980, Cottage's accounting firm gave a similar seminar for financial institutions, which was attended by Cottage's President. On November 10, 1980, Cottage's accountants discussed reciprocal sale transactions with Cottage's Board of Directors, and on that date the Board passed a resolution to enter into such a transaction. (P.A. 23a).

In accordance with the requirements of R-49, on December 31, 1980, Cottage entered into a series of Loan Participation Sale and Trust Agreements with four other unrelated savings institutions (three located in Cincinnati and one in Portsmouth, Ohio). In each transaction, checks

were paid to and from Cottage and its trading partners for the current fair market value of the mortgage loans (computed using an interest rate at December 31, 1980 of 14.863 percent). The transactions resulted in Cottage selling ninety percent mortgage participation interests in 252 of its mortgage loans and purchasing ninety percent mortgage participations in 305 different loans from its trading partners. (P.A. 3a, 24a, 27a).

The participations sold and bought by Cottage all were in loans that had different obligors, were "conventional" loans secured by mortgages on single-family residences, and were current. The underlying security (real estate) for each loan was different. Most of the properties were inside the Cincinnati "beltway". Some of the properties where Cottage was the buyer were as far north as Dayton, Ohio (about 55 miles from Cincinnati) and some were as far east as Jackson, Ohio (about 120 miles from Cincinnati). Of the properties where Cottage was the seller, some were as far north as Middletown, Ohio (about 35 miles from Cincinnati), and some were as far east as Batavia, Ohio (about 25 miles from Cincinnati). (P.A. 28a).

Sales of loan participations (such as the ninety percent participations exchanged in this case) are customary in the savings and loan industry. Cottage made no attempt to determine, prior to the transactions at issue, whether there was a difference between the prepayment potential of the loan participations received by Cottage and those transferred by Cottage. Nevertheless, actual collections received by Cottage did not achieve the equality anticipated at the time of the transfers. The actual payments received by Cottage's trading partners on account of loan participations Cottage sold exceeded the actual payments received by Cottage on participations it purchased by \$191,389 for the period beginning with the date of sale and ending on March 31, 1985. Absent misrepresentations, the party receiving less in actual collections (Cottage) had no recourse against the party receiving more. (P.A. 29a, 30a).

Participation interests are less liquid than whole loans in the secondary market. As a result, after the December 31, 1980 transactions, Cottage and its trading partners were in a less liquid position (except for income tax refunds) than they had been before the transactions. (P.A. 30a).

The December 31, 1980 transactions were between independent parties. The Tax Court held that the transactions were closed and completed; the transactions were bona fide. (P.A. 30a).

SUMMARY OF THE ARGUMENT

A. Cottage's loss was realized, recognized and allowed as a deduction. Sections 165 and 1001 of the Internal Revenue Code provide the statutory framework for this three-part test.⁴

Section 165 basically provides that all losses sustained in a taxable year are deductible. In a case with virtually identical facts, the Fifth Circuit agreed with the Tax Court's decision in this case that the transaction was closed and completed, changed the flow of economic benefits, and did not lack economic substance. Thus, the transaction is clearly within the requirements of Treas. Reg. § 1.165-1(b) and (d) for deduction of a loss. *San Antonio Savs. Ass'n v. Commissioner*, 887 F.2d 577, 592 (5th Cir. 1989), *aff'g* 55 T.C.M. (CCH) 813 (1988). In a similar case, the District of Columbia Circuit also agreed with this holding. *Federal Nat'l Mortgage Ass'n v. Commissioner*, 896 F.2d 580 (D.C. Cir. 1990), *aff'g* 90 T.C. 405 (1988).

The Sixth Circuit in this case agreed with the Tax Court that Cottage's loss was realized and recognized, but held that the loss was not allowed as a deduction

⁴ The "Code" refers to the Internal Revenue Code of 1954 (26 U.S.C.), as amended and in effect during the years in issue. Except as otherwise specifically noted, section references are to the Internal Revenue Code of 1954.

because it was not "sustained" under Section 165. However, the Government's own regulation provides that "a loss is sustained to the extent of the difference between such adjusted basis and the amount realized", and that "gain or loss realized . . . from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained." Treas. Reg. § 1.1001-1(a). (emphasis added).

The Sixth Circuit's decision that Cottage's loss was not sustained under Section 165 was based on two findings: (1) Cottage received, in accordance with R-49's regulatory accounting criteria "substantially identical" mortgages in the exchange, and (2) Cottage did not record the losses on its books. Even if R-49 is relevant, *Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939), *aff'g* 38 B.T.A. 811 (1938) held that mortgages secured by different underlying property are not "substantially identical" for tax purposes. The fact that Cottage did not record the loss on its books is irrelevant for tax purposes. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979).

In the principal case relied on by the Sixth Circuit, *Shoenberg v. Commissioner*, 77 F.2d 446 (8th Cir. 1935), *cert. denied*, 296 U.S. 586 (1935), the taxpayer disposed of and reacquired the exact same property, in contrast to this case where Cottage acquired indisputably different properties.

Finally, the Sixth Circuit's approach in this case frustrates the clear intent of Congress by creating a nonstatutory "wash sale" rule even though it is apparent that this transaction falls outside of the statutory wash-sale provision of Section 1091. Congress addressed the issue of reciprocal mortgage loan transactions in the Tax Reform Act of 1986 when it added Section 56(g)(4)(E) of the Internal Revenue Code. This provision treats seventy-five (75%) percent of the losses from these transactions as a tax preference item subject to the alternative minimum tax.

It is well settled that taxpayers are entitled to arrange their affairs to minimize taxes. *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1935), *aff'd* 293 U.S. 465 (1935). Cottage

exchanged its depreciated mortgage loans for completely different loans and merely chose the time it wished to take its loss for tax purposes. Its loss is clearly deductible under Section 165.

B. Cottage's transfer of mortgages resulted in a realized loss regardless of whether the mortgages it received met the "materially different" requirement of Treas. Reg. § 1.1001-1(a), because there is no "materially different" requirement in the statutory language of Section 1001. Further, the legislative history supports the conclusion that Section 1001 is merely computational.

Section 1001(a) is entitled "Computation of Gain or Loss" and Section 1001(b) is entitled "Amount Realized". Sections 1001(a) and (b) had their origins in Section 202 of the Revenue Act of 1924, Pub. L. No. 68-176, 43 Stat. 253. The legislative history of Section 202 demonstrates that the purpose of this section was "to show clearly the method of determining the amount of gain or loss from the sale or other disposition of property". (Emphasis added). See H.R. Rep. No. 179, 68th Cong., 1st Sess. 12 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 13 (1924).

Section 1001(c) requires (except as otherwise provided by a statutory nonrecognition provision) that the entire amount of all realized gains or losses must be recognized. Congress' intention in enacting the predecessor of Section 1001(c) (Section 203 of the Revenue Act of 1924) was to enact a broadsweeping recognition requirement and then except specific transactions in which it is not desired to tax the gain or allow the loss. S. Rep. No. 398, 68th Cong., 1st Sess. 14 (1924). None of the nonrecognition provisions of the Code apply to the instant case and the Government has not contended otherwise (except to the extent that Section 1001 may be viewed as a nonrecognition provision). (P.A. 34a). Treasury Regulations confirm that the nonrecognition rules are "exceptions from the general rule requiring the recognition of all gains and losses" and these rules "are strictly construed and do not extend beyond the words or the

underlying assumptions and purposes of the exception." Treas. Reg. § 1.1002-1(a) and (b).

Moreover, Congress acted specifically to exclude notes or evidences of indebtedness from the like-kind exchange rule in 1923. Sec. 202(c), Revenue Act of Mar. 4, 1923, Pub. L. No. 67-545, 42 Stat. 1560. Committee reports acknowledge that the result of the like-kind exchange rule is that while profit and loss on some exchanges are not recognized, that "profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money . . ." H.R. Rep. No. 704, 73d Cong., 2d Sess. 13 (1934). This exclusion continues to exist today in Section 1031(a). Thus, Section 1001(c) acts to require Cottage to realize and recognize its loss.

Treas. Reg. § 45, art. 1563, promulgated in 1920, permitted a loss to be realized on an exchange if property received was "essentially different" from property disposed of. However, the Government eliminated this "essentially-different" language from the regulation after Congress adopted the broadsweeping recognition requirement in 1924. Both the Tax Court in this case (P.A. 38a) and the District Court in *First Federal of Temple* recognized that the Government abandoned this essential-difference requirement. *First Fed. Savs. & Loan Ass'n of Temple v. United States*, 694 F. Supp. 230, 240 n.11 (W.D. Tex. 1988).

Finally, early cases establish that realization of income or loss is triggered by either a disposition of the taxpayer's property for completely different property or by an exchange for a different interest in the same property. *Weiss v. Stearn*, 265 U.S. 242 (1924); *Marr v. United States*, 268 U.S. 536 (1925). The mortgages Cottage received were clearly different from the mortgages it transferred and its loss must be realized under the tax law.

C. Even assuming that Treas. Reg. § 1.1001-1(a) correctly states the law that realization of gain or loss requires that the property exchanged must differ "materially either in kind or extent", Cottage's transaction met

this materially different test and Cottage's loss should be realized. *Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939), *aff'd* 38 B.T.A. 811 (1938), is relevant because it involved sales and purchases of bonds secured by pools of mortgages and the definition of "substantially identical" for purposes of the wash sale provision of the predecessor of Section 1091. The Third Circuit in *Hanlin* held that bonds secured by different collateral were not substantially identical "by geographic definition." 108 F.2d at 431. The Tax Court in this case found that Cottage's transaction met the materially different standard in the regulation and specifically found that Cottage's position was even stronger than the taxpayer in *Hanlin*. (P.A. 45a).

Moreover, Treas. Reg. § 1.1001-1(a) does not require that properties in an exchange "differ materially for economic purposes" or "differ materially and predictably in economic risk" or that a taxpayer must be "richer or poorer" as the result of the exchange for realization to occur. If it did, no taxpayer would ever realize gain or loss on an arms-length transaction because parties are always in the same economic position immediately before a transaction as immediately after. Thus, Cottage's loss on the exchange of mortgage loans for completely different mortgage loans should be realized and recognized under Section 1001 and allowed as a deduction under Section 165.

ARGUMENT

I. SECTION 165 OF THE CODE DOES NOT PRECLUDE THE DEDUCTION OF THE LOSS REALIZED AND RECOGNIZED BY COTTAGE.

A. COTTAGE PROPERLY DEDUCTED ITS LOSS BECAUSE THE LOSS WAS REALIZED, RECOGNIZED AND ALLOWED AS A DEDUCTION UNDER SECTIONS 1001 AND 165 OF THE CODE.

Cottage properly deducted its loss under the provisions of the Internal Revenue Code, because the loss was (1) realized, (2) recognized, and (3) allowed as a deduction. Sections 1001 and 165 provide the statutory framework for this three part test.

The pertinent provisions of Section 1001 (a) through (c) provide as follows:

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

- (a) COMPUTATION OF GAIN OR LOSS - The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
- (b) AMOUNT REALIZED - The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received . . .
- (c) RECOGNITION OF GAIN OR LOSS - Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

Section 165(a) provides as follows:

SECTION 165. LOSSES.

- (a) **GENERAL RULE** – There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Even though Section 1001(a) is entitled "Computation of Gain or Loss," it is understood to include the realization requirement. See 2 B. Bittker, *Federal Taxation of Income, Estates and Gifts*, ¶40.2 at 40-4 (1981).

The Tax Court held that Cottage's loss on the reciprocal mortgage sale was realized, recognized and allowed as a deduction under Section 165. (P.A. 52a). The Sixth Circuit agreed that Cottage realized and recognized its losses, but reversed the decision of the Tax Court because it said the losses were not "sustained" and thus not allowable under Section 165. (P.A. 10a, 14a). The Fifth Circuit, in a reciprocal mortgage sale case with essentially identical facts, agreed with the Tax Court decision in this case and held that the loss was realized, recognized and allowed as a deduction.⁵ The District of Columbia Circuit, on the same issue and on similar facts, agreed with the Tax Court in this case and with the Fifth Circuit that a

⁵ *San Antonio Savs. Ass'n v. Commissioner*, 887 F.2d 577 (5th Cir. 1989), *aff'g* 55 T.C.M. (CCH) 813 (1988). The facts in *San Antonio* are virtually identical to this case as *San Antonio* was decided by the Tax Court on summary judgment based on an assumption that the facts were essentially the same as in this case. Two other reciprocal mortgage sale cases with similar facts were also decided in the same manner by the Fifth Circuit Court of Appeals. *Centennial Savs. Bank FSB v. United States*, 887 F.2d 595 (5th Cir. 1989), *aff'g in part and rev'g in part*, 682 F. Supp. 1389 (N.D. Tex. 1988), *cert. granted*, 59 U.S.L.W. 3243 (U.S. Oct. 1, 1990) (No. 89-1926), and *First Fed. Savs. & Loan Ass'n of Temple v. United States*, 887 F.2d 593 (5th Cir. 1989), *aff'g* 694 F. Supp. 230 (W.D. Tex. 1988). *Centennial* will be argued in tandem with this case.

loss from a reciprocal mortgage sale transaction is deductible.⁶

B. ALL REALIZED LOSSES FROM SALES OR EXCHANGES OF PROPERTY ARE "SUSTAINED" UNDER SECTION 165.

All realized losses from sales or exchanges of property are "sustained" under Section 165. Treas. Reg. § 1.1001-1(a). While the Sixth Circuit concluded that Cottage "realized" losses on the exchanges of its mortgages, and that those losses must be "recognized," it held that they were not deductible under Section 165 because they were not "sustained." This interpretation of the tax law is not only squarely contradicted by Treas. Reg. § 1.1001-1(a), it has been rejected by every other court that has considered mortgage exchange transactions.⁷

Treas. Reg. § 1.1001-1(a) explicitly states that if a taxpayer's amount realized from a sale or exchange is less than his adjusted basis in the property, "a loss is sustained to the extent of the difference between such adjusted basis and the amount realized." (Emphasis added.) In addition, the Regulation states that "gain or loss realized . . . from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained." (Emphasis added). Treas. Reg. § 1.1001-1(a). Thus, according to the Regulation, as long as the property exchanged is materially different, then every "realized" loss is "sustained".⁸

⁶ *Federal Nat'l Mortgage Ass'n v. Commissioner*, 896 F.2d 580 (D.C. Cir. 1990), *aff'g* 90 T.C. 405 (1988). In fact, the District of Columbia Circuit in *Federal National Mortgage Association* rejected "the Sixth Circuit's reasoning and result in favor of the more persuasive analysis of the Fifth Circuit and the Tax Court . . ." 896 F.2d at 584.

⁷ See, e.g., the cases set forth in Notes 5 and 6, *supra*.

⁸ Judge Cohen, in her concurring opinion in the Tax Court, held that the property exchanged by Petitioner did not have to

(Continued on following page)

Every judge in the Tax Court who addressed the issue held that the mortgage loans in this case were materially different. (P.A. 40a). The Tax Court (in contrast with the decision of the Sixth Circuit) correctly held that Cottage's loss was sustained and deductible under Section 165. (P.A. 52a). Nothing in Section 165 or the regulations thereunder is contrary to this conclusion.

C. THE SIXTH CIRCUIT'S TEST FOR WHEN A LOSS IS SUSTAINED IS CONTRARY TO PRECEDENT.

The Sixth Circuit held that no losses were sustained based on two findings: Cottage (1) received "substantially identical" mortgages in the exchange, and (2) did not record the losses on its books (*i.e.*, for nontax regulatory accounting purposes). (P.A. 14a). Both findings are unfounded and contrary to established authority.

With regard to its first finding, the Sixth Circuit apparently based its finding that Cottage received "substantially identical" mortgages in the exchange on the fact that Cottage complied with the requirements of R-49 so that its mortgages were "substantially identical" for regulatory accounting purposes.

However, that Cottage met the criteria of R-49 only proves that the mortgages received by Cottage were of a similar general nature to those that it transferred in the reciprocal mortgage transaction.⁹ In fact, the stated purpose of the ten criteria set forth in Memorandum R-49

(Continued from previous page)

be materially different in order to sustain a loss (P.A. 54a) and the Sixth Circuit seems to agree with Judge Cohen. (P.A. 9a). As discussed *infra* at p. 26, Cottage's position is that there is no "materially different" requirement.

⁹ The ten criteria of Memorandum R-49 themselves prove only that the mortgages exchanged are similar. In fact, four of the criteria (2, 5, 8, and 9) use the word "similar." (P.A. 3a, 19a, 20a).

was that the "criteria represented our *attempt* to maintain the association's position with respect to three types of risks in a loan portfolio".¹⁰ (Emphasis added). It is not relevant with respect to the tax law whether property received in an exchange presents the same or different risks with respect to the property transferred.

In addition, the opportunity for savings and loan associations not to report a loss from the reciprocal loan transactions which met the criteria of R-49 was *optional*, not compulsory. Thus, even if Memorandum R-49 were somehow relevant to the instant case, its holding is simply that a savings institution has an option to *report or not report a loss* for financial purposes. That fact, we submit, undermines the relevance of Memorandum R-49 to the interpretation of the tax law.¹¹

In any event, the courts have not accepted the pronouncements of nontax regulatory agencies as determining tax results. This point was strongly made by the Tax Court below in rejecting the binding effect of R-49 on the tax law. Judge Chabot of the Tax Court specifically

¹⁰ Memorandum from the Director of the OES to the Executive Staff Director of the Bank Board. (P.A. 2a).

¹¹ The relevance of Memorandum R-49 has also been undermined by Statement of Position ("SOP") 90-3 issued on February 13, 1990 by the Accounting Standards Division of the American Institute of Certified Public Accountants. SOP 90-3 concludes that debt instruments are "substantially the same" only if the instruments have the same primary obligor and meet five other criteria. It specifically notes that exchanged pools of single-family mortgages would not be considered substantially the same because the mortgages exchanged would not have the same primary obligor. While the FHLBB had permitted institutions which complied with R-49 to treat single-family mortgages exchanged as substantially identical for regulatory accounting purposes and consequently not to report the resulting losses on their books, SOP 90-3 now clarifies that losses incurred from any such exchanges should be reported for financial accounting purposes.

rejected Judge Sanders' statement in the *Centennial* case that a taxpayer cannot (by complying with R-49) "have his cake and eat it too," in other words, deduct a loss for tax purposes without booking a loss for regulatory accounting purposes. (P.A. 51a, 53a).

That Cottage received "substantially identical" mortgages is also directly contrary to *Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939), *aff'g* 38 B.T.A. 811 (1938), which held that mortgages secured by different underlying properties are not "substantially identical" for tax purposes.¹² Finally, the Tax Court specifically found that the mortgages exchanged by Cottage were "materially different".¹³

The Fifth Circuit in *San Antonio* provides the best explanation of how mortgages could be materially different for tax purposes while substantially identical for regulatory accounting purposes as well as the weight to be given to the FHLBB's determination of substantial identity. The Court stated:

Admittedly at first glance the statement that two items can at the same time be "substantially identical" and "materially different" seems illogical. The critical consideration is, however, that the "substantially identical" language is employed by the FHLBB as an administrative accounting matter to carry out its own regulatory obligations. The "materially different"

¹² A complete discussion of the *Hanlin* case is set forth *infra* at p. 47. Moreover, the holding that the exchanged mortgages were substantially identical in the present case was particularly unwarranted because the Tax Court did not rely solely on *Hanlin's* rule that mortgages with different underlying properties are not "substantially identical"; the Tax Court went further and, based on the trial record, found as a matter of fact that the exchanged mortgages were likely to (and subsequently did) behave differently. (P.A. 37a).

¹³ See discussion of Tax Court's finding of material difference at pp. 48-50, *infra*.

requirement is employed by a different agency, the IRS, in carrying out its separate regulatory responsibilities. Each of these phrases is a regulatory statement created for and used for a different administrative purpose.

The IRS urges that under *Ford Motor Credit Co. v. Milhollin*, 444 U.S. 555, 100 S. Ct. 790, 63 L.Ed 2d 22 (1980), the determinations of regulatory agencies are to be granted respect. So they are - but as to both the IRS and the FHLBB. The FHLBB is not in the business of interpreting the Internal Revenue Code. So also the IRS is not supposed to interpret the Federal Home Loan Bank Act. Here the IRS is arguing that deference should be shown in a tax determination case to a ruling by an agency which is not charged with enforcing the tax code. The FHLBB held that mortgages in R-49 exchanges are "substantially identical" for its own accounting. The IRS would have us defer to the FHLBB on the "substantial identity" but not on the "material difference" of the loans, and it would apply the "substantial identity" ruling (an accounting ruling) to the tax standard of "material difference." "[I]t has been consistently held that the accounting requirements of regulatory agencies are not controlling in the application of the revenue laws, which establish their own standards." *Bellefontaine Federal Savs. & Loan Ass'n. v. Commissioner*, 33 T.C. 808, 811-812 (1960). Hence, the FHLBB's determination that mortgages exchanged in an R-49 transaction are "substantially identical" for its accounting purposes is of no direct relevance when examining whether mortgages under R-49 are "materially different" for purposes of the Internal Revenue Code.

887 F.2d at 591.

The mortgage loans Cottage received in the reciprocal sale transaction pursuant to the requirements of R-49

may have been similar to the mortgage loans it transferred; but, they were certainly not "substantially identical" in accordance with *Hanlin*, 108 F.2d 429, and in fact were held by the Tax Court to be "materially different."

The second finding of the Sixth Circuit, namely, that Cottage did not record the loss on its books, is equally deficient. Under *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), the treatment of a transaction on a taxpayer's books does not control its tax treatment. Therefore, Cottage's failure to record the loss on its books is irrelevant for tax purposes.

D. THE SIXTH CIRCUIT'S DECISION IS UNSUPPORTED BY THE AUTHORITIES UPON WHICH IT RELIES.

The Sixth Circuit's decision in this case relies heavily upon *Shoenberg v. Commissioner*, 77 F.2d 446 (8th Cir. 1935), *cert. denied*, 296 U.S. 586 (1935), and *Horne v. Commissioner*, 5 T.C. 250 (1945). This reliance is misplaced. Those cases involved transactions in which a taxpayer disposed of and reacquired the *same* property rights. Thus they are inapplicable to transactions (such as those at issue here) in which indisputably *different* properties were exchanged. Moreover, the results reached in both of those cases were supported by statutory non-recognition rules – the predecessor to Section 1091 in *Shoenberg*¹⁴ and the

¹⁴ The taxpayer in *Shoenberg* tried to avoid the wash-sale rule in Section 118 of the Revenue Act of 1928 by having the stock he sold at a loss immediately repurchased by his controlled corporation, which then waited slightly more than 30 days to sell the stock back to him. The Eighth Circuit stated: "For all practical purposes, he used [his corporation] as an agency for purchasing, holding, and selling to him, stocks identical with those he sold to establish the claimed loss." 77 F.2d at 449 (emphasis added). Under agency principles, the sale and repurchase fell within the statutory wash-sale rule, resulting in the disallowance of the losses at issue.

predecessor to Section 1031 in *Horne*¹⁵ – whereas no non-recognition rule is applicable to the transactions at issue here.

In addition, the Sixth Circuit improperly extended *Shoenberg's* rationale for denying a loss deduction, *viz.*, that the taxpayer is "no poorer than before the sale" because the identical stock was repurchased. 77 F.2d at 499. The taxpayer in *Shoenberg* was "no poorer" after the transactions because he ended up with the *exact same* property. However, the tax law cannot require – as the Sixth Circuit suggests – that taxpayers be poorer as the result of an exchange involving *different* properties in order for a loss to be deductible; if it did, taxpayers would be entitled to a deductible loss only in the event of a bad bargain. See *San Antonio*, 887 F.2d at 590 ("[r]ealization does not require that a taxpayer must be 'richer or poorer' as a result of the exchange itself" [original emphasis]).

The Sixth Circuit also misinterprets the "sham" and "substance-over-form" cases cited in its opinion (none of which is based on Section 165). *Keats v. United States*, 865 F.2d 86 (6th Cir. 1988), involved silver straddle transactions in which the taxpayer had no risk of loss and in fact suffered no real economic losses. In contrast, it is undisputed that Cottage suffered *real economic losses* on the mortgages exchanged in its transaction. In *Davis v. Commissioner*, 585 F.2d 807 (6th Cir. 1978), *cert. denied*, 440 U.S.

¹⁵ The taxpayer in *Horne* purchased one certificate representing a "seat" on a stock exchange and sold another certificate to take a tax loss. The Tax Court held: "[T]he result was the same as if he had exchanged his certificate for that of another member. The deduction of a loss on such an exchange, that is, an exchange of property held for productive use in trade or business for property of a like kind to be held for such use, is expressly denied by Section 112(b)(1) of the Internal Revenue Code [now Section 1031(a)(1)]." *Horne*, 5 T.C. at 256. See *Perlin v. Commissioner*, 86 T.C. 388, 430 n.36 (1986) (characterizing *Horne* as a Section 1031 case).

981 (1979), the Court disregarded purported sales of apartment complexes to taxpayers by their wholly owned corporations, concluding the corporations had not in substance transferred the assets to the taxpayers. On the other hand, it is undisputed that the subject mortgage participations were actually transferred to new owners by Cottage. In *Owens v. Commissioner*, 568 F.2d 1233 (6th Cir. 1977), the Court held that the purchase for cash of stock in a shell corporation whose only asset was cash should be treated as an exchange of cash for cash, rather than a sale of the equity of a business. In contrast, it is undisputed that the assets exchanged by Cottage were in fact different mortgages.

There is no dispute in this case that Cottage suffered a loss on its mortgage loans when interest rates rose because of circumstances in the marketplace beyond its control. It is also undisputed that Cottage entered into the original transactions (the lending of money secured by mortgages) in the ordinary course of its savings and loan business. Cottage merely chose the time it wished to take its loss.¹⁶ There was clearly a business purpose in originally acquiring the various mortgage loans Cottage later exchanged in the transaction at issue.

The case of *Widener, Trust No. 5 v. Commissioner*, 80 T.C. 304 (1983), *acq.* 1984-2 C.B. 2, is instructive in the reciprocal sale area. In *Widener*, the Tax Court held that a reciprocal sale of stock between two trusts produced a deductible loss under Section 165 of the Code to each trust, despite each trust's admitted motive to realize tax losses to offset portfolio gains in the same year. *Id.* at 310. Further, the court found that even though both trusts had the same beneficiary, they were not related in a tax sense

¹⁶ See *Terry v. United States*, 10 F. Supp. 183 (D. Conn. 1934), which holds that if property is acquired in a transaction entered into for profit, a bona-fide loss incurred on disposing of the property is deductible even if the taxpayer sells it at a particular time in order to establish a tax loss.

but were separate taxpayers, and that the sales had substance because each trust permanently terminated its ownership of the stocks sold and the income flow they produced. *Widener, Trust No. 5*, 80 T.C. at 313. Cottage, like the taxpayer in *Widener*, entered into an arms-length transaction that resulted in a change in the flow of economic benefits. Just as in *Widener*, Section 165 allows Cottage's deduction of its losses in this case.

E. THE SIXTH CIRCUIT'S DECISION ATTEMPTS TO CREATE A NON-STATUTORY WASH-SALE RULE.

The Sixth Circuit applies a standard that is tantamount to a nonstatutory "wash-sale" rule within the framework of Section 165. The statutory wash-sale rule of Section 1091 denies loss deductions where a taxpayer sells or otherwise disposes of "stock or securities" and, within 30 days before or after such an event, acquires "substantially identical" stock or securities. Because mortgages are not stock or securities, Section 1091 cannot be applied in this case, and the Internal Revenue Service has not contended otherwise.¹⁷ The Sixth Circuit's decision effectively ignores Section 1091's limitation to stock or securities. This approach makes the statutory limitation meaningless, frustrating the clear intent of Congress and creates a judicially imposed nonstatutory wash-sale rule for mortgage transactions.

Recent Congressional action illustrates that the Government's approach in this case is contrary to the intent of Congress in the reciprocal mortgage loan transaction area. In the Tax Reform Act of 1986, Congress enacted a new alternative minimum tax. It treated as a preference item to be included in "alternative minimum taxable income" seventy-five (75%) percent of the loss recognized

¹⁷ The government conceded that none of the non-recognition sections of subtitle A of the Internal Revenue Code (which includes Section 1091) apply to this case. (P.A. 34a).

"on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities." Section 56(g)(4)(E) of the Internal Revenue Code of 1986. Congress would thus treat seventy-five (75%) percent of Cottage's loss (if it occurred today) as a preference item for the alternative minimum tax calculation, an obvious disincentive for any savings institution to engage in a reciprocal mortgage loan transaction. Congress (not the courts) is the proper party to change the tax laws and it has recently chosen to do so in this area.

F. SECTION 165 DOES NOT PREVENT DEDUCTION OF COTTAGE'S LOSS.

Section 165 does not prevent deduction of Cottage's loss. It provides, in general, that all losses sustained in a taxable year are deductible unless compensated by insurance or otherwise. Moreover, nowhere does Section 165 limit the losses of corporations, while it does limit the losses of individuals.¹⁸ The Regulations under Section 165 provide that a loss must be evidenced by a closed and completed transaction, must be fixed by an identifiable event, and must be bona fide. Treas. Reg. § 1.165-1(b) and (d). The Regulations further provide that in determining the existence of these factors, substance shall control and not form. Treas. Reg. § 1.165-1(b). The Fifth Circuit in *San Antonio* concurred with the Tax Court's finding in this case that the transaction was closed and completed, changed the flow of economic benefits, and did not lack economic substance.

¹⁸ Section 165(c) specifically limits the losses of individuals to certain types of transactions but contains no provision which limits the losses of Cottage. See *International Trading Co. v. Commissioner*, 484 F.2d 707 (7th Cir. 1973), rev'g 57 T.C. 455 (1971) (Corporate loss allowed on property not held for business or investment purposes).

The Fifth Circuit in *San Antonio* then stated that Section 165 and Treas. Reg. § 1.165-1(b) simply do not prevent allowance of the loss in this case:

The government's argument with reference to § 165 is a different facet of its previous argument that the loss sustained by SASA was not economically real. Even if it is conceded (as it was for summary judgment purposes) that there was no purpose for the R-49 transaction other than tax reduction, nevertheless SASA suffered a real economic reduction in the value of the mortgage participation interests it transferred and the economic reality of that loss was fixed by an identifiable event, an exchange of materially different items.

San Antonio, 887 F.2d at 592. The District of Columbia Circuit agreed that Section 165 does not prevent deduction of a loss in a reciprocal mortgage loan transaction. *Federal Nat'l Mortgage Ass'n v. Commissioner*, 896 F.2d 580 (D.C. Cir. 1990), aff'g 90 T.C. 405 (1988).

It is well settled that taxpayers are entitled to arrange their affairs to minimize taxes. *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), aff'd 293 U.S. 465 (1935). See also *Sullivan v. United States*, 618 F.2d 1001, 1007-1008 (3rd Cir. 1980) which held that "there is nothing sinister in arranging one's affairs so as to minimize taxes." The taxpayer in this case merely chose the time it wished to take its loss and minimize its taxes. Memorandum R-49 permitted Cottage to exchange some of its mortgage loans for similar, but different loans and, at the same time, avoid recording the loss on its books if it chose to do so.

Cottage sustained a real, economic loss, which loss should be allowed for income tax purposes under Section 165.¹⁹ This Court should adopt the proper reasoning of

¹⁹ It is interesting to note that when Cottage exchanged its depreciated mortgage loans for the mortgage loan participations of its trading partners, Cottage ended up with a basis in

(Continued on following page)

the Fifth Circuit (and D.C. Circuit) that Section 165 does not prevent the deduction of Cottage's loss and reject the reasoning of the Sixth Circuit Court of Appeals.

II. COTTAGE'S TRANSFER OF MORTGAGES RESULTED IN A REALIZED LOSS, AS A MATTER OF LAW, REGARDLESS OF WHETHER THE MORTGAGES COTTAGE RECEIVED DIFFERED MATERIALLY FROM THE MORTGAGES COTTAGE TRANSFERRED.

A. THERE IS NO "MATERIALLY DIFFERENT" REQUIREMENT; SECTION 1001 REQUIRES THE RECOGNITION OF GAIN OR LOSS ON ALL EXCHANGES UNLESS A STATUTORY EXCEPTION APPLIES.

There is no "materially different" requirement for a loss on an exchange to be realized. In fact, Section 1001(c) requires that the entire amount of all realized gains or losses must be recognized unless a statutory nonrecognition provision applies.

The Government has previously argued that the first sentence of Treas. Reg. § 1.1001-1(a) limits realization of loss under Section 1001 to transactions in which property is exchanged for "other property differing materially in kind or in extent". In other words, it creates a substantive test for realization. There is no such "materially different" requirement in the statutory language of Section 1001. Moreover, the legislative history of Section 1001 discussed below supports the conclusion that Section 1001 is merely computational.

(Continued from previous page)

its new loans that was lower than its original basis in its old loans. This new basis was equal to the fair market value of the new mortgage loans it received. Thus, while Cottage received a current loss deduction, it is currently reporting income on these new mortgage loans as principal payments are received.

The Sixth Circuit (P.A. 9a), the District Court in *First Federal Savings & Loan Association of Temple v. United States*, 694 F. Supp. 230 (W.D. Tex. 1988) and the concurring Tax Court judges, herein, all held that neither Section 1001(a) nor Treas. Reg. § 1.1001-1(a) states a substantive test for realization.

1. Sections 1001(a) and (b) merely set forth the manner of computing the amount realized on a transaction, and do not create a statutory standard for realization.

Sections 1001(a) and (b) merely set forth the manner of computing the amount realized on a transaction and do not create a statutory standard for realization. Section 1001(a), entitled "Computation of Gain or Loss," and Section 1001(b), entitled "Amount Realized," had their origins in Section 202 of the Revenue Act of 1924, Pub. L. No. 68-176, 43 Stat. 253 (hereinafter the "1924 Act"). The purpose of this section was "to show clearly the *method* of determining the *amount* of gain or loss from the sale or other disposition of property." (Emphasis added); see H.R. Rep. No. 179, 68th Cong., 1st Sess. 12 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 13 (1924). This computational method codified existing law, but did not codify a standard for realization. Subsequent legislative history also treats these provisions as merely computational in nature. See, e.g., H.R. Rep. No. 1, 69th Cong., 1st Sess. 5 (1926) (discussing the methods for determining how much depreciation is to be deducted in calculating the basis of property for determining gain under these provisions).

As Professor Bittker explains, Section 1001(a) "is purely computational; it determines the *amount* of the taxpayer's gain or loss but leaves to other provisions the task of determining whether the amount so computed is taxable or deductible, recognized or not recognized, and capital or ordinary." 2 B. Bittker, *Federal Taxation of Income, Estates and Gifts*, ¶ 43.1 at 43-1 (1981).

2. Section 1001(c) provides a general rule that, except as otherwise provided in the Code, all gain or loss is recognized from all exchanges.

Section 1001(c) provides generally that, except as otherwise provided in the Code, all gain or loss is recognized from all exchanges. Prior to the enactment of the original predecessor of Section 1001(c), gain or loss was not recognized on an exchange of property unless the property received had a "readily recognizable market value." Section 202(c) of the Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 227 (hereinafter the "1921 Act"). Troubled that "[t]he provision is so indefinite that it cannot be applied with accuracy, nor with consistency," Congress enacted Section 203 of the 1924 Act. (See H.R. Rep. No. 179, 68th Cong., 1st Sess. 13 (1924)). Congress explicitly stated its intention to enact a broadsweeping recognition requirement:

It appears best to provide generally that *gain or loss is recognized from all exchanges* and then except specifically and in definite terms those cases of exchanges in which it is not desired to tax the gain or allow the loss. This results in definiteness and accuracy and enables a taxpayer to determine prior to the consummation of a given transaction the tax liability that will result therefrom.

Id. (emphasis added); S. Rep. No. 398, 68th Cong., 1st Sess. 14 (1924). Thus, Congress moved from a case-by-case analysis of recognition based on the market value of the assets received to a blanket rule that all gain or loss on an exchange is recognized in the absence of an applicable statutory exception.

Because gains and losses that are recognized must necessarily be realized, Congress' mandate that gain or loss be recognized on all exchanges necessarily acknowledges that gain or loss is realized on all exchanges. By requiring that "the entire amount of the gain or loss" on the exchange of property, as determined under Section 202 of the 1924 Act (the computational rules discussed in

the preceding section), "*shall be recognized*" except as otherwise provided, Section 203(a) of the 1924 Act effectively required recognition (and realization) of gain or loss on all exchanges except in the case of specific exceptions.

The Code provisions at issue in this case reflect the Congressional intent set forth above: Section 1001(c) – the successor to Section 203 of the 1924 Act – provides generally that all gain or loss is recognized from all exchanges, except as otherwise provided in Subtitle A of the Code.²⁰ The entire amount of gain or loss on the exchange of property to be so recognized is measured under Section 1001(a) and (b) (which includes the successor to the computational rules of the 1924 Act). The Code then provides for nonrecognition of gain or loss in certain limited circumstances such as like-kind exchanges (Section 1031), wash sales (Section 1091), stock-for-stock exchanges (Section 1036), and certain other corporate reorganizations (e.g., Section 354). The Government has never contended that any nonrecognition provision in Subtitle A of the Code applies to the transfer of the mortgage loan participations in dispute (except to the extent that Section 1001 may be viewed as a nonrecognition provision). (P.A. 34a). Moreover, regulations confirm that the nonrecognition provisions are "exceptions from the general rule requiring the recognition of all gains and losses," Treas. Reg. § 1.1002-1(b);²¹ and these rules "are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception," Treas. Reg. § 1.1002-1(b).

²⁰ Several rulings published by the Internal Revenue Service also state this rule. See, e.g., I.T. 2896, Vol. XIV-1 C.B. 96 (Jan.-Jun. 1935) (explaining that [under the 1924 version of this statutory requirement], "*every exchange results in a gain or loss for income tax purposes unless the exchange comes within one of the statutory exceptions*") (emphasis added).

²¹ The substance of Section 1002 was moved into Section 1001(c) pursuant to the Revenue Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

3. A 1920 Regulation does not establish a "materially different" standard under Section 1001.

Treas. Reg. § 45, art. 1563, was promulgated in 1920. Contrary to the Government's arguments below, this regulation does not establish a "materially different" standard under Section 1001. This regulation, which was superseded over fifty years ago, permitted a loss to be realized on an exchange only if the property received was "essentially different" from the property disposed of.²² Treasury eliminated the "essentially-different" language from the regulation after Congress adopted the broad-sweeping recognition requirement in 1924. Both the Tax Court below (P.A. at 38a) and the District Court in *First Federal of Temple* determined that Treasury abandoned this essentially different requirement. *First Fed. Savs. & Loan Ass'n of Temple v. United States*, 694 F. Supp. 230, 240 n.11 (W.D. Tex. 1988).

The history of the statutory sections interpreted by this 1920 regulation further confirms that the deletion of the essential-difference requirement was intentional. The 1920 regulation interpreted Section 202(b) of the Revenue Act of 1918, Pub. L. No. 65-254, 40 Stat. 1057 (1919) (hereinafter the "1918 Act"), which provided that "[w]hen property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value" except in the context of certain corporate reorganizations. In other words, all exchanges required an analysis of the property received, including a determination of the fair market

²² Assuming *arguendo* that the 1920 regulation (rather than the current regulation) is controlling, and that the reference to "essentially different" embodies a "material difference" test, it is a test that Cottage's exchanges meet. See discussion *infra* at p. 43. All eleven judges who joined in the Tax Court opinion below agreed.

value of that property. This was the law when, in 1920, Treasury promulgated this regulation. According to the regulation, a gain or loss on an exchange of property under this statutory property exchange rule is realized if the property received is (1) "essentially different from the property disposed of," and (2) has a market value. Treas. Reg. § 45, art. 1563 (1920 ed.).

Unfortunately, the 1918 version of Section 202(b) gave rise to substantial uncertainty and litigation, forcing Congress to amend it in 1921. Observing that, prior to its amendment, Section 202 created a presumption in favor of taxation, the Senate Finance Committee explained that the new language "modifies that presumption by providing that in the case of an exchange of property for property no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value . . ." S. Rep. No. 275, 67th Cong., 1st Sess. 11 (1921) (emphasis added).²³ Congress thus adopted Treasury's market-value standard, but did not adopt Treasury's essential-difference standard. Moreover, the statutory limitation on recognition of gains and losses from property exchanges adopted in 1921 indicates that such exchanges do give rise to realization, notwithstanding the 1920 regulation.

Three years later, in an effort to provide more certainty in the tax law, Congress enacted Section 203 of the 1924 Act – the original predecessor to 1001(c) – and thereby intentionally adopted a blanket rule that all gain or loss on an exchange is recognized in the absence of an applicable statutory exception. The 1920 regulation was inconsistent with Congress' intent to create a rule of certainty in Section 203; thus, it was properly abandoned.

²³ See Appendix for text of Section 202(c) of the Revenue Act of 1921, as amended.

4. The legislative history of the statutory exceptions to recognition explicitly acknowledges that loss is realized and recognized on exchanges of notes, without regard to a materially different standard.

The legislative history of the nonrecognition provisions, including the like-kind exchange rule, shows that gain or loss is realized on all exchanges. In 1921 Congress amended Section 202(c) of the Act to provide an exception to recognition of gain or loss "[w]hen any such property held for investment or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use." Sec. 202(c)(1) of the 1921 Act. Because this like-kind exchange rule provoked wide-spread abuse by taxpayers seeking to shield their gains from recognition,²⁴ Congress acted, in 1923, to exclude "stock, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest" from the like-kind exchange rule. Sec. 202(c), Revenue Act of Mar. 4, 1923, Pub. L. No. 67-545, 42 Stat. 1560. This exclusion existed in 1980 (as it does today) in Section 1031(a). The result of excluding "notes or other evidences of indebtedness" from the like-kind exchange rule is that there is no nonrecognition section to apply to Cottage's exchange. Accordingly, Section 1001(c) acts to require Cottage to recognize its loss on the transaction at issue.

²⁴ According to A. W. Melon, Secretary of the Treasury in 1923; "Many brokers, investment houses and bond houses have established exchange departments and are advertising that they will exchange securities for their customers in such a manner as to result in no taxable gain." Letter from A. W. Melon to the Hon. William R. Green (Jan. 13, 1923), H.R. Rep. No. 1432, 67th Cong., 4th Sess. 1-2 (1923). The abuse was especially troublesome because cash consideration received in addition to the exchanged securities also escaped taxation. *Id.*

Legislative history confirms that, because notes are excluded from Section 1031, an exchange of notes is taxable. The language of Section 1031(a) in 1980 is the verbatim language used in the 1934 version of the like-kind exchange rule.²⁵ In 1934, when Congress declined to change that language, the House Report specifically acknowledged that the result of the like-kind exchange rule is that profit and loss on some exchanges are not recognized, but that "*profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money.*" H.R. Rep. No. 704, 73d Cong., 2d Sess. 13 (1934) (emphasis added). In the fifty years since Congress considered amending this provision, it has not done so.²⁶ This Court should not do so now.

This Court recently considered the proper interpretation of statutory exclusions in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988). In that case, the Government argued that the taxpayer's assets must be treated as capital assets because they fell within the literal statutory definition of capital assets, and outside the statutory exclusions from that definition. The Court agreed and noted that the legislative history of the provisions involved supported a conclusion that the statutory exceptions are exclusive. *Id.* at 217. Similarly, the legislative history of the nonrecognition provisions supports a conclusion that these exceptions are exclusive. As conceded by the Government in this case (P.A. 34a), Cottage's loss falls outside any of the nonrecognition provisions. Therefore, Cottage's loss must be recognized.

²⁵ See Appendix for the language of Section 112(b)(1) of the Revenue Act of 1934, Pub. L. No. 73-216, 48 Stat. 680.

²⁶ See discussion of Judge Cohen's concurring opinion in the Tax Court with respect to Section 1031's exclusion of evidences of indebtedness, *infra* at p. 41.

B. THE "REALIZATION TEST" IS SIMPLE: IF THERE HAS BEEN A CHANGE IN THE VALUE OF PROPERTY, THEN GAIN OR LOSS IS REALIZED FOR TAX PURPOSES WHEN A SALE OR OTHER DISPOSITION OF THE PROPERTY OCCURS.

Realization of gain or loss occurs upon a change in value of property when there is a sale or other disposition of the property. Sections 1001(a)-(c). The most eloquent (and accurate) statement of this objective concept of realization appears in Judge Smith's opinion in *First Federal Savings and Loan Association of Temple*, as follows:

Realization is not concerned with a taxpayer's relative economic position before or after a sale or other disposition. Realization has occurred as soon as 1) there has been an actual change in net worth of a taxpayer's property (it is undisputed that the loans had depreciated in value) and 2) there has been a sale or other disposition of the property (it is undisputed that there was at least an exchange of loan pools which qualified as an "other disposition"). Whether the "exchange" or "other disposition" involves property which is of like kind or is not materially different has nothing to do with the realization of any gain or loss associated with the sale or other disposition of property for it is at that point that the decline in value of property can be fixed due simply to the fact of the transaction regardless of its economic consequences.

694 F. Supp. at 240.

A taxpayer's relative economic position is not relevant with respect to realization.²⁷ Taxpayers are always in

²⁷ In this case, if Cottage had sold its depreciated loans (or participations in mortgage loans) in the open market for cash, it clearly would have realized and recognized a deductible loss for tax purposes. If Cottage then had taken these cash proceeds and either repurchased different mortgage loans in the open

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the same economic position immediately before a sale as immediately after a sale if the transaction was bona-fide and at arms length.²⁸ It is undisputed that Cottage incurred an economic loss when its mortgages declined in value. It is also undisputed that Cottage disposed of its mortgages in a bona-fide arms-length transaction. (P.A. 52a). Cottage's loss is clearly realized.

1. *Eisner v. Macomber* established that a mere increase or decrease in the value of a taxpayer's asset does not constitute income or loss.

It is well established that no gain or loss is realized on a mere increase or decrease in the value of a taxpayer's assets.²⁹ Cottage did not automatically "realize" a loss for tax purposes when the value of its mortgages declined as a result of increasing interest rates, although its loss was a very real economic loss. Its loss, albeit real, was not "realized" until an identifiable event occurred that fixed the time and amount of the loss under Sections 1001(a) and 1001(b).

This general rule was not always so clear, however, and early judicial authority painstakingly articulated the

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market or originated new mortgage loans, it would still be in the same economic position even though it clearly disposed of its mortgages in a bona-fide arms-length transaction.

²⁸ For example, a sale of a \$100 mortgage worth \$80 for \$80 in cash results in realization of a \$20 loss. The seller and buyer are both in the same economic position just before the sale as after because both still have property worth exactly \$80. See discussion of the District Court's misunderstanding of this concept in *Centennial*, *supra* note 32 at p. 37.

²⁹ In the absence of this general rule, thousands of taxpayers would realize gain or loss with respect to their stock investments regularly - even on a daily basis - as the market fluctuates.

standards for determining when a gain or loss is realized. In *Eisner v. Macomber*, 252 U.S. 189 (1920), this Court discussed at length the circumstances in which a taxpayer should realize income, holding that receipt of a stock dividend does not result in taxable income.³⁰ In essence, this Court focused on whether there had been some identifiable event, rather than a mere change in value, that would trigger taxable income.

In *Eisner v. Macomber*, the taxpayer had received a stock dividend that increased the number of her shares, but not her ownership percentage, of the corporation. She did not sell, transfer, or in any way dispose of any assets. Moreover, the stock distributed to the taxpayer did not provide her with any additional claim to corporate earnings. This Court therefore had to decide if the taxpayer should recognize a gain on her stock dividend, notwithstanding the fact that she had not disposed of her stock and had not received anything different from what she already owned.

This Court's attention to the fact that "the corporation is no poorer and the stockholder is no richer than they were before," *Eisner* at 203, reflected its determination that the stock dividend did not effect a transfer from the corporation to the shareholder, i.e., that the shareholder had not "received or drawn . . . for his separate use, benefit and disposal" an amount that could be treated as income. *Id.* at 207 (emphasis in original).³¹ In *Eisner v.*

³⁰ The issue in *Eisner v. Macomber*, 252 U.S. 189 (1920), whether Congress had the power to tax a stock dividend as income, arose under the Revenue Act of September 8, 1916, 39 Stat. 756 *et seq.* That *Eisner v. Macomber* reflects the early stages of the realization analysis is evidenced by the fact that four Justices, including Mr. Justice Brandeis and Mr. Justice Holmes, dissented from this landmark opinion.

³¹ It is useful to note that the Supreme Court paid little heed to the economists' theories. *Eisner v. Macomber*, 252 U.S. at 206. As R. Magill observes, "one cannot tell whether the Court

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Macomber, there simply had been no identifiable event to effect a change in the taxpayer's rights. By contrast, after Cottage's transfer of the 252 mortgages to the other institutions, those mortgages were no longer Cottage's property and Cottage no longer had any rights, or any business risks, with respect to those transferred mortgages.

The conclusion in *Eisner v. Macomber* that no income was realized on the stock dividend because "the corporation is no poorer and the stockholder is no richer than they were before," also reflects the rule that there is no realization without some change in the taxpayer's economic position. Absent some increase or decrease in value (like the one incurred by Cottage when its mortgage portfolio declined in value) there can be no gain or loss even if the taxpayer disposes of his asset.³²

Gain or loss, if any, is realized on an asset at the point at which the taxpayer relinquishes all dominion and control of his asset. Section 1001(a); *See Commissioner v. Brown*, 380 U.S. 563 (1965). For the taxpayer in *Eisner v. Macomber*, that point never came. For Cottage, that point

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regarded the definitions of economists as theoretically unsound; or whether, on account of various unexpressed practical considerations, the Court decided that a different definition would work better." R. Magill, *Taxable Income* 19 (Rev. ed. 1945).

³² The District Court in *Centennial Savs. Bank FSB v. United States*, 682 F. Supp. 1389 (N.D. Tex. 1988), *aff'd in part and rev'd in part*, 887 F.2d 595 (5th Cir. 1989), *cert. granted*, 59 U.S.L.W. 3243 (U.S. Oct. 1, 1990) (No. 89-1926), misunderstood this test to require that the taxpayer be richer or poorer *immediately after* the exchange than *immediately before*. Under that test, no gain or loss would ever be realized on any fair market value exchange - because both parties to the exchange would own exactly the same value immediately after the exchange as immediately before if they were dealing at arms length.

was December 31, 1980, when it relinquished all dominion and control of 252 mortgages.

2. Subsequent judicial authority established that the realization of income or loss can be triggered by either a disposition of the taxpayer's property or by an exchange for a different interest in the same property.

The realization test enunciated in subsequent cases (set forth below) does not require that exchanged properties differ materially – it requires only that a taxpayer (1) sell or otherwise dispose of his property, or (2) exchange the property for a different interest in the same property. These cases establish guidelines for determining what differences must exist between exchanged properties to trigger realization without a disposition of the taxpayer's original property. The cases conclude that a taxpayer may realize gain or loss with respect to property without disposing of his interest in the property, if he receives an interest in the property that is "essentially" or "materially" different from his original interest in the same property.

This Court held in *Weiss v. Stearn* that for a taxable gain to occur in an exchange, the taxpayer must receive "a thing really different than what he theretofore had". *Weiss v. Stearn*, 265 U.S. 242 (1924). In *Weiss v. Stearn*, the shareholders of the original corporation exchanged their stock for half the stock in a new corporation with the same business, plus cash from a third party.

The Court in *Weiss v. Stearn* concluded as follows:

We cannot conclude that a mere change for purposes of reorganization in the technical ownership of an enterprise . . . followed by issuance of new certificates constitutes gain separated from the original capital interest. Something more is necessary – something which gives the stockholder a thing really different from what he theretofore had. (Emphasis added.)

265 U.S. at 254. Therefore, the old shareholders were taxed on the cash sale but not on the exchange of the old shares for new shares.

The narrow scope of the nonrealization rule in *Weiss* was emphasized shortly thereafter in *Marr v. United States*, 268 U.S. 536 (1925). In *Marr*, a taxpayer received a different interest in the same corporation, and therefore realized income. *Marr* involved a corporation that was organized under the laws of a different state, but received the assets and assumed the liabilities, from the old corporation. The taxpayer received stock in the new corporation in exchange for his stock in the predecessor corporation. The "business enterprise" in which the taxpayer held stock remained exactly the same. The Government argued, and this Court agreed, that gain in value must be realized when the gain is " . . . represented by an essentially different interest in the same business enterprise or property." 268 U.S. at 540 (emphasis added).

In *Marr*, the formality of a legally different transferee was all the Government said was needed to "realize" gain; and realization occurred, it argued, where the seller received either (1) an interest in different property, or (2) a different interest in the same property.³³ Thus, a "realization event" occurred when the taxpayer exchanged stock in one corporation for stock in a successor corporation with the same assets and business as the original corporation, notwithstanding the court's finding that the taxpayer had not sold or otherwise disposed of his interest in the property.³⁴ *Marr* thus limits the *Weiss*

³³ The Supreme Court so summarized the Government's argument in *Marr*.

³⁴ In order to avoid the harsh consequences that would result from taxing these reincorporation transactions, Congress thereafter enacted yet another nonrecognition statute, Section 368(a)(1)(F), that provides a statutory exception to the general rule that a reincorporation of a corporation produces a recognized gain or loss. This nonrecognition provision, like the ones cited earlier, would be unnecessary if the exchange was not a realization event.

nonrealization rule to the narrow circumstances where the taxpayer has before and after the *same* interest in the *same* property.

Emery v. Commissioner, 166 F.2d 27 (2d Cir. 1948), *aff'g* 18 T.C. 1979 (1947), utilized this Court's "different interest in the same property" test for realization which was developed in the early Supreme Court cases. In *Emery*, the taxpayer exchanged bonds for bonds of the *same* obligor (the City of Philadelphia). Thus, the taxpayer continued to hold his interest in Philadelphia bonds. The new bonds were convertible into registered form, but were identical in all other respects. Although the taxpayer had clearly not disposed of the city's obligation to him, the court held that he nonetheless recognized income; he had received "something really different from what he theretofore had." *Emery*, 166 F.2d at 30.

These cases emphasize that when a taxpayer retains the *same* rights in the *same* asset there has been no "identifiable event" to trigger realization. Unless the taxpayer receives different property or a different interest in his property, there has in essence been no real "exchange"; the taxpayer continues to hold what he had before – not merely something substantially similar. The mortgages Cottage received were clearly different mortgages from the mortgages it transferred because they had different obligors and different collateral. Cottage also ended up with a different interest in the property, namely, participations in mortgage loans. (P.A. 37a). Thus, Cottage met the different property test as well as the different interest test even though realization only requires it meet one such test. The tax law requires that its loss must be realized.

C. JUDGE COHEN'S CONCURRING OPINION IN THE TAX COURT, THAT THERE IS NO MATERIALLY DIFFERENT REQUIREMENT, IS LEGALLY CORRECT.

Judge Cohen's concurring opinion (P.A. 54a) in the Tax Court, which states that there is no materially

different requirement in Section 1001, is legally correct. She states that Treas. Reg. § 1.1001-1(a) deals strictly with computation of gain or loss. The essence of her opinion rests less on a debate about the converse of Treas. Reg. § 1.1001-1(a)³⁵ than on the argument that Treas. Reg. § 1.1001-1(a) is subordinate to the statute (Section 1001(c)), and, under the statute, "as a matter of law there is no requirement applicable in this case that the properties exchanged differ materially in kind or in extent." (P.A. 56a).³⁶ The Sixth Circuit's decision in this case seems to agree with Judge Cohen's approach. (P.A. 9a, 10a).

On the particular facts here, Judge Cohen appears to believe that the mortgages did represent different property rights *by reason of* the different obligors and collateral on the respective groups of mortgages. Hence, there were different property rights exchanged and realization did occur within the meaning of Section 1001.³⁷

Finally, Judge Cohen points out that the only relevant nonrecognition provisions are the like-kind exchange rules of Section 1031 and the wash sale rules of Section 1091. Since neither sections are applicable here, and "Section 1031 expressly excludes applicability of the 'like-kind' exchange rules to evidence of indebtedness", she suggests applying the maxim "*Expressio unius est exclusio alterius*" (the expression of one thing implies the exclusion of another thing). In other words, since mortgages were specifically excluded from the like-kind exchange

³⁵ Judge Chabot's discussion about the converse of Treas. Reg. § 1.1001-1(a) is set forth at P.A. 38a, 39a note 13 and 14. Judge Cohen's concurring opinion is fully set forth at P.A. 54a-56a.

³⁶ It is obvious that Judge Cohen would not find realization in an exchange of identical property based upon the early Supreme Court cases (*See discussion supra* at pp. 35-40).

³⁷ An accurate statement of the concept of realization appears in Judge Smith's opinion in *First Federal of Temple* at p. 34.

rules of Section 1031, Congress obviously intended that exchanges of mortgages must therefore be realized and recognized. The Government's very own regulation requires such a result. Treas. Reg. § 1.1002-1(b).³⁸

D. ADOPTION OF THE GOVERNMENT'S THEORY WOULD CREATE AN ADMINISTRATIVE NIGHTMARE.

The adoption of the Government's theory in this case, that material differences are a prerequisite to realization, and that economic substitutes cannot be materially different, would create an administrative nightmare. If this theory is adopted, then the Congressional goal (expressed in 1924 relating to what is today Section 1001) of providing taxpayers with some certainty with respect to recognition of gains and losses will never be met.³⁹ Taxpayers and courts will spend countless hours trying to determine whether property received on an exchange is "materially different" from, or a mere economic substitute for, the property transferred. Every exchange will create fact issues worthy of jury trials and economic experts, all in the name of "convenience."

Under the Government's theory, taxpayers who exchange shares of one mutual fund for another and can prove that the aggregate stock investment of one fund was not economically different from the other, will be able to defer taxation of gain indefinitely.⁴⁰ Congress closed this door in 1924. This Court should not reopen it now.

³⁸ The entire text of Treas. Reg. § 1.1002-1(b) is set forth in the Appendix at 4a.

³⁹ See discussion of Section 203 of the Revenue Act of 1924, Pub. L. No. 68-176, 43 Stat. 253, *supra* at p. 28.

⁴⁰ See Discussion of *Centennial* opinion, *supra* note 32, at p. 37.

At best, taxpayers – and the courts – will face enormous, costly burdens and much confusion in determining whether property exchanged is materially different. At worst, a new era of tax shelters will begin as taxpayers seek to shield their gains by exchanging appreciated property for other economically similar property.

III. EVEN IF A "MATERIALLY DIFFERENT" STANDARD DID APPLY TO THE TRANSACTIONS AT ISSUE, THE TAX COURT WAS CORRECT IN CONCLUDING THAT THE MORTGAGES COTTAGE RECEIVED WERE MATERIALLY DIFFERENT FROM THE MORTGAGES COTTAGE TRANSFERRED AND COTTAGE'S LOSS SHOULD BE REALIZED AND RECOGNIZED.

A. SIMILARITY OF RISKS AND ECONOMIC SIMILARITY HAVE NO APPLICATION IN TAX LAW.

The Government has argued below that there is an alleged similarity of "risks" or "economic similarity" with respect to the mortgages transferred and received by Cottage and this should act to prevent Cottage from deducting its loss. However, the tax law does not turn on economists' or laymen's concepts and similarity of risks and economic similarity have no application in the tax law.⁴¹ The notions of "realization" and "recognition" are tax concepts without parallel in other professional disciplines. The measurement of comparable income streams may have significance to economists. However, the tax law depends exclusively on practical concerns of administering the law.

Judge Korner's opinion for the Tax Court in *Federal National Mortgage Association v. Commissioner*, 90 T.C. 405 (1988), provides, we think, the definitive statement from

⁴¹ This Court rejected the necessity of risk-shifting in the context of determining whether a sale took place in *Commissioner v. Brown*, 380 U.S. 563 (1965).

the tax standpoint about "risk" factors and economic analysis of income streams with respect to mortgages exchanged by savings and loans. The Tax Court pointed out that economic analysis relates to the relative fair market values of the obligations exchanged, and that equality of fair market values is not relevant taxwise to the question of whether realization of gain or loss has occurred. The Court stated:

The fact that the market values of the two pools of mortgages exchanged were the same, or almost the same, is not determinative. Current market value reflects an amalgam of the interest rate, the face amount and the maturity of the obligation. It is not necessarily a clear reflection of the value of the underlying security, the credit-worthiness of the borrower, or of varying local economic circumstances which may have future effect on these factors. The first mortgage bond of railroad A is not the same property in kind or quality as first mortgage bond of food processing company B, even though the two bonds may carry the same face amount, the same rate of interest, the same maturity, and may happen, at the moment, to be quoted at the same price in the open market. We hold that the similarities here do not result in there being no material differences in the mortgages.

90 T.C. at 423.

Professor Roswell Magill best articulated the fundamental difference between the operation of our tax system in the area of realization from sales or exchanges of property, and the approach of economics and other professions. His book, *Taxable Income*, makes these points in connection with the pre-statutory reorganization decisions of the Supreme Court, discussed earlier. R. Magill, *Taxable Income* (rev. ed. 1945). Several of the relevant passages express Professor Magill's points as follows:

Weiss v. Stearn and *Marr v. U.S.* may be reconciled upon the basis of formal differences in their facts, notably the differences in the states

of incorporation, and in the characteristics of the new securities, referred to in the majority opinion. But it is clear that the division of opinion between the majority and the minority in *Marr v. U.S.* cuts more deeply. The majority sanctions computation and taxation of the accumulated gain when the stockholder receives securities legally different in kind; the minority would not, if the two enterprises are substantially identical. The test of the majority is clearly much easier of application by administrative officials. It has the further virtue of leaving Congress comparatively untrammelled by constitutional restrictions in working out methods for the taxation of reorganizations, a factor of great practical significance.

* * *

It is clear, in the first place, that the Court did not regard a mere accretion in value during the taxable year as constituting income; there must have been some change in the form or the extent of the taxpayer's investment. *But there need be no substantial change in the character of the investment, if a formal change has occurred . . .* A change in the form or extent of an investment is easily detected by a taxpayer or an administrative officer. It affords a reasonable and convenient occasion for taking stock of the accretion in value to the investment as represented by the distribution which the stockholder has received. Such a policy of taxing gains obviates valuations so far as possible on the one hand, and an indefinite postponement of the taxation of accrued gains on the other." (Emphasis added).

Taxable Income, 76-80.⁴² Professor Magill's comments with respect to taxation of gains are equally applicable to the taxation of losses.

The Government has argued below that the marketplace perceived the mortgages exchanged by Cottage

⁴² R. Magill, *Taxable Income* (rev. ed. 1945).

as equivalent. Section 1001 could not be administered if this Court (or other courts) had to define a relevant "marketplace" and then determine exactly how that market "perceived" the mortgage loans exchanged in a reciprocal sales transaction.⁴³

The Government has previously argued that mortgages that are economic substitutes for one another are not materially different, and since a taxpayer is in the same economic position before and after the exchange of such mortgages, there is no realization. However, Treas. Reg. § 1.1001-1(a), to the extent it is not just computational and places a precondition upon loss realized in an exchange, requires only that property being exchanged differ "materially in either kind or extent." It does not say "differing materially for economic purposes" or "differing materially and predictably in economic risk." And, it, most assuredly, does not say that a taxpayer must be "richer or poorer" as the result of the exchange itself.

It is true that Cottage may not have been overly concerned with individual differences in the mortgages it exchanged in the R-49 transaction. However, a seller's personal views of the financial characteristics of the properties exchanged, or "market" similarities between the properties sold and received, are not relevant to a determination of realization. We have reiterated throughout this brief that the tax determination of whether gain or loss has been realized turns on objective factors. The Government would surely insist on that rule if *gain* were involved in an exchange; would the Government concede that a taxpayer can escape realization of *gain* on an exchange of similar kinds of investment properties or

⁴³ Any transaction involving similar assets would be perceived by the marketplace as equivalent. See the example at note 44, *infra*.

even on an exchange of mortgages which meet the criteria of R-49?⁴⁴ We think not.

The objective factors which determine that the mortgages in this transaction are materially different are the different obligors, the different underlying collateral (real estate), the different interest (participations) in the mortgages and the different collections received by Cottage on the loan participations. (P.A. 37a). No other difficult-to-measure concepts of "economic reality" or similarity are relevant for this purpose. It is also not necessary to penetrate into the subjective attitudes of the parties to an exchange to determine how they may have individually focused on specific characteristics of the properties they were exchanging. Likewise, the practicalities of administering the law do not require the courts to undertake broad studies of how investors generally view the characteristics of the properties involved in a particular exchange.

B. THE HANLIN CASE REQUIRES THAT THIS COURT AFFIRM THE TAX COURT'S DECISION THAT THE MORTGAGE LOANS COTTAGE TRANSFERRED WERE "MATERIALLY DIFFERENT" FROM THE MORTGAGE LOANS IT RECEIVED AND THUS ITS LOSS SHOULD BE REALIZED AND RECOGNIZED.

The Third Circuit decision in *Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939), *aff'g* 38 B.T.A. 811 (1938) requires that this Court affirm the Tax Court's decision that the mortgage loans Cottage transferred were "materially different" from the mortgage loans it received. Its loss should thus be realized and recognized. *Hanlin* is

⁴⁴ For instance, would the Government allow a taxpayer to escape gain if he exchanged an Exxon bond for a Mobil bond, both with identical interest rates, par value, maturities and fair market value just because the taxpayer was unconcerned with the differences in the companies issuing the bonds and because the marketplace valued these bonds at the same price?

particularly relevant because it involved sales and purchases of bonds secured by pools of mortgages. *Hanlin* dealt with the applicability of the wash sale provision of the Code (the predecessor of current Section 1091) and the definition of "substantially identical" for purposes of such Section with respect to two different kinds of transactions: (1) a sale and purchase of various bonds of the same issuer, and (2) sales and purchases of various bonds of different issuers.

The Third Circuit held that the same-issuer bonds were substantially identical to each other, but that the different-issuer bonds were not substantially identical. A reading of the Third Circuit's opinion reveals that the court did test substantial identity in the *same-issuer* transaction somewhat by reference to the attitudes of ordinary investors, but did not apply such a test where the issuers of the bonds sold and purchased were not the same. Although the Tax Court (Board of Tax Appeals) decision in *Hanlin* had found lack of substantial identity among the different-issuer bonds by reason of the different issuers, the Third Circuit rested its rejection of the wash sale limitation on the fact that the Land Bank bonds in situation (2) were all secured by physically different collateral. The Court stated:

Though the average sense of obligation may well be the same, even an economist must recognize, *by geographical definition*, a salient divergence in, say the type (and marketability) of crops produced – or, perhaps, the likelihood of dust storms. This difference, we think, deprives the bonds of one Land Bank of substantial identity with those of another.

108 F.2d at 431 (emphasis added).

Cottage exchanged mortgages with different obligors and different underlying real estate collateral. In such a transaction, the real estate risks are inherently different and there are differences, as stated by the *Hanlin* decision, "by geographical definition." It should also be emphasized that the Tax Court specifically found that

Cottage's position in the instant case was *even stronger* than the taxpayer in *Hanlin* with respect to the bonds of the different Federal Land Banks. (P.A. 45a).

It should not be necessary to review and compare the lifestyles and job prospects of individual homeowners (and their propensity to pay their mortgages) and the real estate investment values of their residences in order to determine whether gain or loss was "realized" on an exchange of mortgages. Our tax system would become impossible to administer if this were necessary.

It is interesting to note that Memorandum R-49 takes geographical differences into account. For instance, R-49 requires that the mortgage loans be in the same state. Yet if this or other factors of the R-49 criteria were not satisfied in some minor detail (such as real estate collateral in two different states but close in physical proximity and economic climate), would the Government necessarily allow a loss deduction? The Government's position that mortgages of different issuers secured by different collateral are not materially different would destroy effective tax administration.

It is impossible to believe this Court will undo the basic administrative concepts which have long underlay the fundamental concepts of tax "realization" of gain or loss.

Therefore, even assuming that Treas. Reg. § 1.1001-1(a) correctly states the legal requirement (which we dispute) that realization occurs from an "exchange of property for other property differing materially in kind or extent", the Tax Court (with ten judges agreeing with Judge Chabot's majority opinion) carefully reviewed all of the evidence before it⁴⁵ and concluded that "the property petitioner acquired differs 'materially . . . in kind' from the property petitioner transferred." In fact, the Sixth Circuit's opinion in this case agreed with the Tax Court that Cottage's loss was realized and recognized:

⁴⁵ In fact, the Tax Court "scrutinized the record with particular care." (P.A. 36a).

We believe the loss in this case was technically realized in the sense that an earlier decline in value of the fixed-rate mortgage loans was fixed by an identifiable event – the “reciprocal sales” transaction. Since there is no Code exception that applies, under 1001(c) the loss must be recognized. (P.A. 10a).

The mortgage loans Cottage received in the transaction at issue are clearly materially different from the mortgages it transferred.⁴⁶ Cottage’s loss on the exchange of mortgage loans for other mortgage loans (with different obligors and collateral underlying the mortgages) should be realized and recognized under Section 1001 and Treas. Reg. § 1.1001-1(a). For the reasons stated above, the loss should also be allowed as a deduction under Section 165.

CONCLUSION

For the foregoing reasons, the decision of the Court of Appeals for the Sixth Circuit should be reversed.

Respectfully submitted,

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⁴⁶ In addition to different obligors and underlying real estate securing the mortgages, the Tax Court found that the transaction “clearly changed the flow of economic benefits” to Cottage as collections on the loans were not equal, and the participations that Cottage ended up with were a different type of ownership than the mortgages it originally owned. (P.A. 30a, 37a).

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.)

§ 165 *Losses*

(a) *General rule.* There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

§ 1001 *Determination of Amount of and Recognition of Gain or Loss.*

(a) *Computation of Gain or Loss.* The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.* The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized –

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account any amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) *Recognition of Gain or Loss.* Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

§ 1031 *Exchange of Property Held for Productive Use or Investment.*

(a) *Nonrecognition of Gain or Loss from Exchanges Solely in Kind.* No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

Treasury Regulations on Income Tax (26 C.F.R.)

§ 1.165-1 (b)

(b) *Nature of loss allowable.* To be allowed as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

§ 1.165-1 (d)

(d) *Year of deduction.* (1) A loss shall be allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. . . . [Remaining portions, which are not pertinent to sales or exchanges, are omitted]

§ 1.1001-1 *Computation of gain or loss.*

(a) *General rule.* Except as otherwise provided in Subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001(a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (*i.e.*, the cost or other allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the

taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder. Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by transfer in trust).

Treas. Reg. § 1.1002-1.

(a) *General rule.* The general rule with respect to gain or loss realized upon the sale or exchange of property as determined under section 1001 is that the entire amount of such gain or loss is recognized except in cases where specific provisions of subtitle A of the Code provide otherwise.

(b) *Strict construction of exceptions from general rule.* The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the

specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

(c) *Certain exceptions to general rule.* Exceptions to the general rule are made, for example, by sections 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035 and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

(d) *Exchange.* Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

PRIOR REVENUE ACTS

Revenue Act of 1918

BASIS FOR DETERMINING GAIN OR LOSS.

Sec. 202. (b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or other property exchanged.

Revenue Act of 1921.

BASIS FOR DETERMINING GAIN OR LOSS.

Sec. 202. (c) For the purposes of this title, on a exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized -

(1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use;

Act of March 4, 1923.

FOR DETERMINING GAIN OR LOSS.

Sec. 202. (c) . . .

(1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale, and in the case of property held for investment not including stock, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidence of indebtedness or interest), is exchanged for property of a like kind or use.

. . .

Revenue Act of 1924.

DETERMINATION OF AMOUNT OF GAIN OR LOSS.

Sec. 202. (a) Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in subdivision (a) or (b) of section 204, and the loss shall be the excess of such basis over the amount realized.

(b) In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for (1) any expenditure properly chargeable to capital account, and (2) any item of loss, exhaustion, wear and tear, obsolescence, amortization, or depletion, previously allowed with respect to such property.

(c) The amount realized from the sale or other disposition of property shall be the sum of any money

received plus the fair market value of the property (other than money) received.

(d) In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 203.

(e) Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

RECOGNITION OF GAIN OR LOSS FROM SALES AND EXCHANGES.

Sec. 203. (a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.

(b) (1) No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment, or if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

Revenue Act of 1934.

Sec. 112(a) RECOGNITION OF GAIN OR LOSS.

General rule. – Upon the sale or exchange of property the entire amount of gain or loss, determined under Section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges solely in Kind.* –

(1) Property held for productive use or investment – No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

REGULATIONS

Treas. Reg. § 45 (1920 ed.)

Art. 1563. Exchanges of property. – Gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or into property (a) that is essentially different from the property disposed of and (b) that has a market value. In other words, both (a) a change in substance and not merely in form, and (b) a change into the

equivalent of cash, are required to complete or close a transaction from which income may be realized. By way of illustration, if a man owning ten shares of listed stock exchanges his stock certificate for a voting trust certificate, no income is realized, because the conversion is merely in form; or if he exchanges his stock for stock in a small, closely held corporation, no income is realized if the new stock has no market value, although the conversion is more than formal; but if he exchanges his stock for a Liberty bond, income may be realized, because the conversion is into independent property having a market value. "Market value" is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade. Property received in exchange for other property has no "fair market value" for the purpose of determining gain or loss resulting from such exchange when, owing to the condition of the market, there can be no reasonable expectation that the owner of the property, though wishing to sell and any person wishing to buy will agree upon a price at which to trade unless one or the other is under some peculiar compulsion. It does not follow that property has no "fair market value" merely because there is no price therefor established by public sales or sales in the way of ordinary business. The property received in exchange may be real estate, personal property, or a chose in action. Where the owner of a bond exercises the right, provided for in the bond, of converting the bond into stock in the obligor corporation, such transaction does not result in a realization of profit or loss, the transaction not being closed for purposes of income taxation until such stock is sold.

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No. 89-1965

In the Supreme Court of the United States

OCTOBER TERM, 1990

COTTAGE SAVINGS ASSOCIATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

**ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT**

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a substantially identical group of mortgage loans held by another financial institution.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statutory provisions and regulation involved	2
Statement	2
Summary of argument	6
Argument:	
Petitioner did not realize a deductible loss on the swap of one group of mortgage loans for another substantially identical group of mortgage loans ...	9
A. A deductible loss is realized on an exchange of property only if the property transferred is materially different from the property received	11
B. The mortgage loans exchanged by petitioner were not materially different	30
Conclusion	35

TABLE OF AUTHORITIES

Cases:

<i>Chevron U.S.A. Inc. v. NRDC, Inc.</i> 467 U.S. 837 (1984)	7, 15, 19
<i>City Bank Farmers Trust Co. v. Hoey</i> , 52 F. Supp. 665 (S.D. N.Y. 1942), aff'd, 138 F.2d 1023 (2d Cir. 1943)	12, 27
<i>Commissioner v. Court Holding Co.</i> , 324 U.S. 331 (1945)	14
<i>Commissioner v. Crichton</i> , 122 F.2d 181 (5th Cir. 1941)	25
<i>Eisner v. Macomber</i> , 252 U.S. 189 (1920)	8, 20, 21
<i>Emery v. Commissioner</i> , 166 F.2d 27 (2d Cir. 1948)	12, 23, 24

IV

Cases — Continued:	Page
<i>Federal Nat'l Mortgage Ass'n v. Commissioner</i> , 90 T.C. 405 (1988), aff'd, 896 F.2d 580 (D.C. Cir. 1990), petition for cert. pending, No. 89-1987 ..	13
<i>Gregory v. Helvering</i> , 293 U.S. 465 (1935)	14
<i>Hanlin v. Commissioner</i> , 108 F.2d 429 (3d Cir. 1939)	33
<i>Helvering v. Horst</i> , 311 U.S. 112 (1940)	17
<i>Helvering v. Sprouse</i> , 318 U.S. 604 (1943)	22
<i>Horne v. Commissioner</i> , 5 T.C. 250 (1945)	27, 28
<i>Koshland v. Helvering</i> , 298 U.S. 441 (1936)	22
<i>Lyng v. Payne</i> , 476 U.S. 926 (1986)	12
<i>Marr v. United States</i> , 268 U.S. 536 (1925)	8, 20, 22-23
<i>Mutual Loan & Sav. Co. v. Commissioner</i> , 184 F.2d 161 (5th Cir. 1950)	12, 26-27
<i>National Muffler Dealers Ass'n v. United States</i> , 440 U.S. 472 (1979)	7, 15, 19
<i>Robertson v. Methow Valley Citizens Council</i> , 109 S. Ct. 1835 (1989)	12
<i>San Antonio Sav. Ass'n v. Commissioner</i> , 887 F.2d 577 (5th Cir. 1989), petition for cert. pending, No. 89-1928	3, 4, 13, 14, 21
<i>Shoenberg v. Commissioner</i> , 77 F.2d 446 (8th Cir.), cert. denied, 296 U.S. 586 (1935)	26, 27
<i>Smith v. Commissioner</i> , 78 T.C. 350 (1982)	27, 28
<i>Square D Co. v. Niagara Frontier Tariff Bureau, Inc.</i> , 476 U.S. 409 (1986)	15
<i>Towne v. Eisner</i> , 245 U.S. 419 (1918)	21
<i>Udall v. Tallman</i> , 380 U.S. 1 (1965)	12
<i>United States v. Correll</i> , 389 U.S. 299 (1967)	15
<i>Weiss v. Stearn</i> , 265 U.S. 242 (1924)	8, 20, 21, 22, 23
<i>West Missouri Power Co. v. Commissioner</i> , 18 T.C. 105 (1952)	12, 27

V

Constitution, Statutes, and regulations:	Page
U.S. Const. Amend. XVI	21
Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 401, 103 Stat. 354	2
Internal Revenue Code of 1954 (26 U.S.C. (1982)):	
§ 56(g)(4)(E) (1988)	28
§ 61	16
§ 61(a)	
§ 61(a)(3)	11
§ 165	2, 6, 10, 16, 34, 35
§ 165(a)	11
§ 1001	2, 5, 6, 7, 8, 15, 16, 17
§ 1001(a)	7, 11, 16, 17, 19, 34, 35
§ 1001(b)	17
§ 1001(c)	7, 8, 16, 18, 19
§ 1002	19
§ 1031	8, 16, 24, 25, 26, 27, 28
§ 1031(a)	25
§ 1091	8, 16, 24, 25, 26, 27
§ 1091(a)	25
Revenue Act of 1921, ch. 136, Tit. II § 202(c), 42 Stat. 227	19
Revenue Act of 1924, ch. 234, 43 Stat. 253	19
§ 202(a), 43 Stat. 255	20
§ 203(a), 43 Stat. 256	19
Tax Reform Act of 1976, Pub. L. No. 99-455, Tit. XIX, § 1901(a)(121), 90 Stat. 1784 (§ 1001(c)) ...	19
Treas. Reg. 45, Art. 1563 (1920 ed.)	12, 20
Treas. Reg. 62, Art. 1564 (1921 Revenue Act)	20
Treas. Reg. 86, Art. 111-1 (1934 Revenue Act)	12

Regulations — Continued:

Page

Treas. Reg.:

Section 1.165-1(b)	34
Section 1.1001-1(a)	2, 7, 11, 18, 27
Section 1.1002-1(a)	18
Section 1.1002-1(b)	18
Section 1.1031(a)-1(b)	25
Section 1.1031(a)-1(c)	25

Miscellaneous:

B. Bittker & J. Eustice, <i>Federal Income Taxation of Corporations and Shareholders</i> (5th ed. 1987)	22
2 B. Bittker & L. Lokken, <i>Federal Taxation of Income, Estates and Gifts</i> (2d ed. 1990)	16, 18, 27
H.R. Rep. No. 179, 68th Cong., 1st Sess. (1924) ..	17, 19, 20
H.R. Rep. No. 704, 73d Cong., 2d Sess. (1934) ...	26
R. Magill, <i>Taxable Income</i> (rev. ed. 1945)	
Rev. Rul. 67-380, 1967-2 C.B. 291	25
S. Rep. No. 275, 67th Cong., 1st Sess. (1921)	20
S. Rep. No. 398, 68th Cong., 1st Sess. (1924) ..	17, 19, 20
S. Rep. No. 938, 94th Cong., 2d Sess. (1976)	17, 19
Winterer, "Reissuance" and Deemed Exchanges Generally, 37 Tax Law. 509 (1984)	13

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-15a) is reported at 890 F.2d 848. The opinion of the Tax Court (Pet. App. 16a-56a) is reported at 90 T.C. 372.

JURISDICTION

The judgment of the court of appeals (Pet. App. 57a) was entered on December 4, 1989. A petition for rehearing was denied on March 14, 1990 (Pet. App. 58a). The petition for a writ of certiorari was filed on June 11, 1990, and granted on October 1, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS AND REGULATION INVOLVED

The relevant portions of Sections 165 and 1001 of the Internal Revenue Code of 1954 (26 U.S.C. (1982)) and Section 1.1001-1(a) of the Treasury Regulations on Income Tax (26 C.F.R.) are set forth at Pet. Br. App. 1a-4a.

STATEMENT

1. Petitioner is a mutual savings and loan association formerly regulated by the Federal Home Loan Bank Board.¹ In 1980, petitioner's mortgage loan portfolio contained many fixed-rate, long-term home mortgage loans that had been issued at interest rates significantly lower than those charged on more recent loans. As a result of the high interest rates of the late 1970s and early 1980s, the fair market value of these older, low-interest loans fell far below their face amount. Pet. App. 2a, 18a.

For petitioner, like other savings institutions holding older, low-interest loans, this situation created a tax incentive for disposing of its depreciated mortgage loans. A disposition of the loans would enable an institution to realize for tax purposes the loss that resulted from these market changes; the institution could then utilize the resulting loss deductions to offset current taxable income and produce loss carrybacks that would generate tax refunds from prior years. There was, however, a problem with a straightforward disposition of the depreciated mortgage loans. Many of these institutions were in such precarious financial condition that a sale of the loans and

¹ In 1989, the Federal Home Loan Bank Board was abolished by statute, and many of its functions were transferred to other federal agencies, including the Office of Thrift Supervision and the Federal Deposit Insurance Corporation. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. 101-73, § 401, 103 Stat. 354.

consequent recognition of the losses—however beneficial for tax purposes—would for regulatory accounting purposes have caused them to fail to meet the Bank Board's minimum reserve and liquidity requirements. See Pet. App. 12a-19a; *San Antonio Savings Ass'n v. Commissioner*, 887 F.2d 577, 579 (5th Cir. 1989), petition for cert. pending, No. 89-1928.

On June 27, 1980, the Bank Board's Office of Examination and Supervision (OES) issued Memorandum R-49, a regulatory accounting principle that adopted the rule that savings institutions could make "reciprocal sales" of "substantially identical mortgage loans" without having to record a loss for regulatory accounting purposes. Pet. App. 19a, 59a-60a. Memorandum R-49 established a list of ten criteria that would render loans "substantially identical," including that the mortgages be of similar type with the same terms and interest rates.² The admitted objective

² Memorandum R-49 provided in part (Pet. App. 59a-60a):

A loss resulting from a difference between market value and book value in connection with reciprocal sales of substantially identical mortgage loans need not be recorded. Mortgage loans are considered substantially identical only when each of the following criteria is met. The loans involved must:

1. involve single-family residential mortgages,
2. be of similar type (e.g., conventionals for conventionals),
3. have the same stated terms to maturity (e.g., 30 years),
4. have identical stated interest rates,
5. have similar seasoning (i.e., remaining terms to maturity),
6. have aggregate principal amounts within the lesser of 2 ½% or \$100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,
7. be sold without recourse,
8. have similar fair market values,
9. have similar loan-to-value ratios at the time of the reciprocal sale, and
10. have all security properties for both sides of the transaction in the same state.

of Memorandum R-49 was to allow savings institutions to engage in transactions that would generate deductible losses for federal income tax purposes, but that would not be treated as giving rise to losses for financial reporting and regulatory purposes. *San Antonio Savings Ass'n v. Commissioner*, 887 F.2d at 579-580; Pet. App. 20a-22a.³

2. On December 31, 1980, petitioner entered into four separate transactions with four other savings institutions designed to exchange interests in mortgage loans that satisfied the requirements of Memorandum R-49. In each transaction, petitioner effectively exchanged a package of 90% participation interests in a group of residential mortgage loans for a package of 90% participation interests in a group of residential mortgage loans held by the other institution. Pet. App. 24a-27a, 32a-33a.⁴ In each transaction, the participation interests exchanged were in loan packages having almost identical face and market value (*id.* at 25a), and the loans involved were "substantially identical" according to the criteria set forth in Memorandum R-49 (*id.* at 30a). In selecting loans to be exchanged, petitioner and its trading partners did not investigate the credit ratings of any of the borrowers on the loans they received and did not investigate the value of the real estate that secured the loans. *Id.* at 4a, 28a. The pricing or valu-

³ A memorandum from the Director of OES to an officer of the Bank Board described the "objective" of Memorandum R-49 as being "to structure a transaction which was as close as possible to the IRS 'materially different' definition which would still not change the economic position of the association after it engaged in the swap." Pet. App. 21a; see *San Antonio Savings Ass'n v. Commissioner*, 887 F.2d at 580.

⁴ Transactions designed to take advantage of Memorandum R-49 often involved exchanges of 90% participation interests, rather than the entire loan, so that the original mortgagee could maintain its relationship with the obligor on the loans. Pet. App. 27a-28a.

ation of all the loans was established by using one common discount factor based on the then-current interest rate of 14.863%. *Id.* at 3a, 25a.

Each transaction was consummated in the form of a "reciprocal sale" by conveyance of the 90% participation interests together with a simultaneous transfer of checks by both parties in the amount of the fair market value of the interests acquired (Pet. App. 3a-4a, 24a-25a). Petitioner paid a total of \$4,456,912 and received a total of \$4,458,855 in the four transactions (*id.* at 25a).⁵ The participation interests that it transferred had a face value of \$6,907,208 (*id.* at 27a). On its 1980 federal income tax return, petitioner claimed a deduction for a loss on the transactions in the amount of \$2,447,091. Exh. 9-1.⁶ Pursuant to Memorandum R-49, petitioner did not report any loss for financial and regulatory accounting purposes (Pet. App. 2a, 30a).

3. On audit, the Commissioner determined that petitioner was not entitled to its claimed deduction for a loss on the mortgage exchange transactions. Petitioner sought redetermination of the resulting income tax deficiencies in the Tax Court. After a trial, the Tax Court held for petitioner (Pet. App. 16a-56a).

The Commissioner's primary argument in the Tax Court was that a loss is "realized" for tax purposes under Section 1001 of the Internal Revenue Code⁷ on an exchange of

⁵ All figures are rounded off to the nearest dollar.

⁶ On its return, petitioner arrived at its claimed loss of \$2,447,091 based on a "gross sales price minus expenses of sale" of \$4,425,416, and "cost or other basis" of \$6,892,506. Exh. 9-1. Petitioner carried back its loss to the years 1974-1979. Pet. App. 31a n.6.

⁷ Unless otherwise indicated, statutory references are to the Internal Revenue Code of 1954 (26 U.S.C. (1982)), as in effect for the year at issue (the Code or I.R.C.).

property only if the exchanged properties are "materially different," and that mortgages that were "substantially identical" under the Memorandum R-49 criteria were not materially different. The Tax Court concluded that the loans petitioner transferred were "materially different" from the loans it received because the loans had different borrowers and were secured by different collateral (Pet. App. 40a-45a). The Tax Court also rejected the Commissioner's additional argument that no loss could be deducted under Section 165 of the Code because the exchange lacked economic substance (*id.* at 51a-52a).

4. The court of appeals reversed (Pet. App. 1a-15a). The court agreed with petitioner's position that a loss was "technically realized" (*id.* at 10a) on the R-49 exchange of mortgages because, in the court's view, Section 1001 of the Code does not require that exchanged properties be "materially different" in order for an exchange to constitute a realization event (*id.* at 9a-10a). The court held, however, that because the exchange of mortgages pursuant to Memorandum R-49 did not result in any real change in petitioner's economic position, petitioner had not sustained a loss on the transactions that would permit it to take a loss deduction under Section 165 of the Code (Pet. App. 10a-15a). In particular, the court stated that loss deductions are not allowed on "transactions in which the taxpayer's economic position was not changed for the worse" (*id.* at 12a-13a), and it concluded that "[petitioner's] economic position was not changed" by an exchange of a pool of mortgages for "a substantially identical pool of mortgages" (*id.* at 14a).

SUMMARY OF ARGUMENT

This case presents the same question as the first question presented in *United States v. Centennial Savings Bank FSB (Resolution Trust Corporation, Receiver)*, No. 89-

1926—whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a "substantially identical" group of mortgage loans in a transaction that complied with the criteria set forth in Federal Home Loan Bank Board Memorandum R-49. As we explain in our brief in *Centennial*, the exchanges of mortgage loans at issue do not produce deductible losses because (1) in order for an exchange of property to produce a deductible loss, the property transferred must be materially different from the property received, and (2) the property transferred in the exchanges at issue is not materially different from the property received.

The Internal Revenue Code takes increases and decreases in the value of property into account only when they are "realized" by a taxable event. See I.R.C. § 1001(a). Under the Commissioner's longstanding interpretation, an exchange of property is not a realization event unless it involves "property differing materially either in kind or in extent." Treas. Reg. § 1.1001-1(a). This materially different aspect of the realization requirement has long been recognized by courts and commentators. The Commissioner's interpretation—embodied in Treasury Regulations for the past 55 years—is reasonable and should be upheld. *Chevron U.S.A. Inc. v. NRDC, Inc.*, 467 U.S. 837, 842-843 (1984); *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 476-477 (1979).

Petitioner argues that the Commissioner has been wrong all these years, and that Section 1001 actually precludes a "materially different" requirement. Petitioner contends that Section 1001(c) of the Code requires realization of gain or loss on all exchanges, unless one of the Code's specific nonrecognition provisions applies. That is an incomplete reading of the text of Section 1001(c). What

Section 1001(c) actually provides is that the gain or loss "determined under this section" shall be recognized, except as otherwise provided in the Code. Whether gain or loss is "determined under this section" depends on whether there has been a realization event. Realization and recognition are separate events in determining the tax consequences of a transaction. The Commissioner's Regulation is a sound and reasonable interpretation of what constitutes realization in the context of a property exchange under Section 1001. Contrary to petitioner's contention, the legislative history of the predecessors of Section 1001 does not indicate that gain or loss necessarily is realized on every exchange of appreciated or depreciated property for different property.

Petitioner's other objections to the materially different requirement are also misconceived. Petitioner mistakenly contends that three early tax decisions of this Court — *Eisner v. Macomber*, 252 U.S. 189 (1920); *Weiss v. Stearn*, 265 U.S. 242 (1924); and *Marr v. United States*, 268 U.S. 536 (1925) — preclude the materially different requirement; in fact, those decisions are entirely consistent with such a requirement. Petitioner also argues that the "materially different" requirement is at odds with the specific nonrecognition provisions of Section 1031, which governs "like kind" exchanges, and Section 1091, which governs "wash sales" of stock or securities. That petitioner's mortgage swap transactions did not fall within these specific nonrecognition provisions, however, does not mean that a loss was realized. Finally, petitioner's claim that a materially different requirement will lead to administrative difficulties is speculative and implausible, ignores the fact that the requirement has been in effect for many years and has not led to such problems, and fails to appreciate that it is the Commissioner who is charged by

law with making policy judgments concerning how best to administer and enforce the Internal Revenue Code.

2. A difference is material if it has the capacity to affect a decision. The available evidence from the conduct and intent of the parties, the evaluation of the market, and the expert judgment of the agency charged with regulating the field establishes that the differences in the swapped loan pools were not material. Although petitioner seeks to exclude evidence from each of these sources, the evidence from these sources is highly relevant and should not be categorically ignored. Petitioner also seeks to rely on differences in borrowers and collateral, on the role of 90% participation interests in the transactions, and on the fact that the loan performances eventually differed. Petitioner thus attempts to rely on a list of factors that either were of no significance to any of the interested parties (respondent and its trading partners, the secondary mortgage market, or the Bank Board) at the time of the transaction or were unknown to them at that time. Petitioner's approach would exalt form over substance and severely undermine the efficacy of the realization requirement by allowing differences of no consequence to any interested party to be deemed "material," thereby permitting a deductible loss for federal tax purposes to be generated by transactions that no one regarded as changing the participants' economic position.

ARGUMENT

PETITIONER DID NOT REALIZE A DEDUCTIBLE LOSS ON THE SWAP OF ONE GROUP OF MORTGAGE LOANS FOR ANOTHER SUBSTANTIALLY IDENTICAL GROUP OF MORTGAGE LOANS

This case presents the same question as the first question presented in *United States v. Centennial Savings Bank FSB (Resolution Trust Corporation, Receiver)*, No. 89-

1926—whether a financial institution realizes a deductible loss for income tax purposes when it exchanges a group of mortgage loans for a “substantially identical” group of mortgage loans in a transaction that complied with the criteria set forth in Memorandum R-49. As we explain in our brief in *Centennial*, the exchanges of mortgage loan packages do not produce deductible losses because (1) in order for an exchange of property to produce a deductible loss, the property transferred must be materially different from the property received, and (2) the property transferred in the exchanges at issue is not materially different from the property received.⁸

Petitioner raises three arguments: (1) the Internal Revenue Code does not require that properties be materially different in order for the exchange to produce deductible losses (Pet. Br. 26-43); (2) if there is a materially different requirement, petitioner’s exchange of “substantially identical” pools of mortgage loans satisfied that requirement (*id.* at 43-50); and (3) regardless of the materially different requirement, Section 165 does not provide an independent basis for denying a deduction for the exchange of substantially identical pools of mortgage loans (*id.* at 13-26). As we explain in our *Centennial* brief, the most straightforward analysis of the mortgage swaps lies in an application of the materially different requirement; a correct application of that principle is sufficient to reject petitioner’s claim to a deduction for the exchange.⁹

⁸ A copy of our brief in *Centennial* has been supplied to petitioner’s counsel.

⁹ As pointed out in our brief in *Centennial* (at 17 n.12), to the extent that the court of appeals’ premise that there is no “materially different” realization requirement in property exchanges is accepted—which, in our view, would be a serious misinterpretation of the Code—we agree with the court below that the deductions nevertheless should be disallowed because the transactions lacked economic

A. A Deductible Loss Is Realized On An Exchange Of Property Only If The Property Transferred Is Materially Different From The Property Received

As we show in our *Centennial* brief (at 13), it is well established that the Internal Revenue Code ordinarily takes into account increases and decreases in the value of property only when gains or losses are realized. In the Commissioner’s view, this realization requirement is derived from Section 1001(a),¹⁰ taken together with the income and loss provisions of Sections 61(a)(3) and 165(a). Exchanges of property, moreover, present particular issues in applying the requirement of realization. As a result, under the Commissioner’s longstanding interpretation, an exchange of property is a realization event only if it involves “property differing materially either in kind or in extent.”¹¹

Petitioner maintains that the materially different aspect of the realization requirement should be rejected, and that the provision of the Treasury Regulations embodying it

substance and thus did not produce losses deductible under Section 165. The same reasons that led to the court of appeals’ Section 165 conclusion, however, also should have led it to conclude that the losses were not deductible because the properties exchanged were not materially different. See note 39 *infra*.

¹⁰ Section 1001(a) provides:

The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

¹¹ See Treas. Reg. § 1.1001-1(a) (“Except as otherwise provided in Subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained”) (emphasis added).

should be invalidated. See Pet. Br. 10, 26, 40-41, 49.¹² The materially different aspect of the realization requirement, however, is well established and properly conceived. It has been in the Treasury Regulations since 1935.¹³ The materially different aspect of the realization requirement has been recognized and applied in numerous judicial decisions.¹⁴ It has been equally well recognized by commenta-

¹² Petitioner does not contend that the Regulation itself fails to embody a materially different requirement for exchanges of property. Cf. Pet. App. 39a & n.14; 54a-55a. Such a contention would violate the principle that an agency's interpretation of its own regulations is "of controlling weight unless it is plainly erroneous or inconsistent with the regulation." *Udall v. Tallman*, 380 U.S. 1, 16-17 (1965). See also *Robertson v. Methow Valley Citizens Council*, 109 S. Ct. 1835, 1850 (1989); *Lyng v. Payne*, 476 U.S. 926, 939 (1986). The Commissioner's longstanding interpretation of the Treasury Regulation obviously accords with the regulatory language.

¹³ See Treas. Reg. 86, Art. 111-1 (1934 Revenue Act). Petitioner points out that an earlier Treasury Regulation (Treas. Reg. 45, Art. 1563 (1920 ed.)) required, among other things, that an exchange of property involve "essentially different" property to be a realization event, and claims that the Commissioner "abandoned" this requirement. Br. 30-31. We fail to see a dramatic difference between the "essentially different" and "materially different" requirements, but, in any event, the materially different language has been in the Treasury Regulations consistently since 1935. Petitioner also points to an isolated ruling in 1935 (Pet. Br. 29 n.20); to the extent that ruling suggests the absence of a "materially different" requirement, it has long been superseded during the 55 years in which the "materially different" requirement has been in the Regulation.

¹⁴ See, e.g., *Mutual Loan & Sav. Co. v. Commissioner*, 184 F.2d 161, 162, 165 (5th Cir. 1950); *Emery v. Commissioner*, 166 F.2d 27, 29-30 (2d Cir. 1948); *City Bank Farmers Trust Co. v. Hoey*, 52 F. Supp. 665, 666 (S.D. N.Y. 1942), aff'd, 138 F.2d 1023 (2d Cir. 1943); *West Missouri Power Co. v. Commissioner*, 18 T.C. 105, 109-111 (1952). In the context of the R-49 transactions, two of the three courts of appeals addressing the issue have reaffirmed the validity of the materially different requirement. See *San Antonio Sav. Ass'n v. Com-*

tors.¹⁵ Indeed, the materially different aspect of the realization requirement is so well known and longstanding that the very structure of the R-49 transactions was based upon an awareness of the requirement.¹⁶

As we also discuss in our *Centennial* brief (at 15), the reason for the materially different aspect of the realization requirement is readily apparent. In the absence of such a requirement, the tax consequences of a disposition of property—a deduction in the case of a loss, income in the case of a gain—would apply even though the taxpayer's economic position remained essentially the same. By definition, an exchange of property involves property that the exchanging parties treat as having equivalent value. Thus, if the exchanged properties are not materially different, the taxpayer has not changed his economic position: he not only retains property of equivalent value, but that property of equivalent value is also not materially different from what he had before. In the absence of a *materially* different requirement, economically meaningless exchanges of identical property—such as 1000 bushels of

missioner, 887 F.2d 577, 581-587 (5th Cir. 1989), petition for cert. pending, No. 89-1928; *Federal Nat'l Mortgage Ass'n v. Commissioner*, 896 F.2d 580, 583 (D.C. Cir. 1990), petition for cert. pending, No. 89-1987. The Tax Court has also applied the materially different requirement in the context of the R-49 transactions. See *Federal Nat'l Mortgage Ass'n v. Commissioner*, 90 T.C. 405, 421-422 (1988), aff'd, 896 F.2d 580 (D.C. Cir. 1990), petition for cert. pending, No. 89-1987; Pet. App. 40a.

¹⁵ See, e.g., Winterer, "Reissuance" and Deemed Exchanges Generally, 37 Tax Law. 509, 512 (1984); R. Magill, *Taxable Income* 143 (rev. ed. 1945).

¹⁶ See Pet. App. 21a (Memorandum from Bank Board entity that issued R-49: "Our objective [in developing the R-49 criteria] * * * was to structure a transaction which was as close as possible to the IRS 'materially different' definition which would still not change the economic position of the association after it engaged in the swap.").

Kansas wheat for a "different" 1000 bushels of Kansas wheat — would constitute realization events and produce tax consequences. See *San Antonio Sav. Ass'n*, 887 F.2d at 583. The end result would be nullification of the realization requirement for losses, since taxpayers with paper losses could engage in repeated meaningless exchanges — say, at the end of every business day in a falling market — and transform those losses into deductions, without altering their economic position. The requirement that exchanged property be materially different if an exchange is to constitute a realization event reflects the fundamental principle of taxation that the substance rather than the form of a transaction determines its tax consequences. See *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945); *Gregory v. Helvering*, 293 U.S. 465, 469-470 (1935).¹⁷

Because the materially different aspect of the realization requirement is a reasonable, longstanding interpretation

¹⁷ Notably, petitioner's position concerning exchanges of identical property — as in the wheat-for-wheat example — is unclear. On the one hand, petitioner's definition of realization (see Pet. Br. 37-38) would seem to require that the exchange constitute a realization event because each party "relinquishes all dominion and control of his asset" in return for the other asset (*id.* at 37). Cf. *San Antonio Sav. Ass'n*, 887 F.2d at 583 (noting taxpayer concession that exchange of identical property is a realization event if there is no materially different requirement and no other specific nonrecognition provision). On the other hand, petitioner seems to indicate that "an exchange of identical property" (Pet. Br. 41 n.36) would not be a realization event. To the extent that petitioner's position is the former, it highlights the importance of the materially different requirement in ensuring that realization is a meaningful concept in exchanges of property. To the extent that petitioner's position is the latter, petitioner has no principled basis, in the absence of a materially different requirement, for excluding exchanges of identical property from the scope of its realization definition.

of the Code, it should be upheld. See *Chevron U.S.A. Inc. v. NRDC, Inc.*, 467 U.S. 837, 843 (1984) ("[I]f the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."); *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 477 (1979) ("Congress has delegated to the Secretary of the Treasury, and his delegate, the Commissioner of Internal Revenue, not to the courts, the task of prescribing all needful rules and regulations for the enforcement of the Internal Revenue Code") (internal quotation marks and brackets omitted); *United States v. Correll*, 389 U.S. 299, 305-307 (1967) ("This case * * * comes within the settled principle that 'Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.' * * * The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner.").¹⁸ Petitioner's request to invalidate the materially different aspect of the realization requirement falls far short of shouldering the formidable burden that such a request entails.

2. Petitioner raises a variety of arguments in support of its claim: the provisions of Section 1001 and their legislative history preclude the materially different requirement (Pet.

¹⁸ In light of the venerable judicial decisions recognizing and applying a materially different requirement to exchanges of property (see note 14, *supra*), it is also appropriate to invoke "the strong presumption of continued validity that adheres in the judicial interpretation of a statute." *Square D Co. v. Niagara Frontier Tariff Bureau, Inc.*, 476 U.S. 409, 424 (1986). Here, the Internal Revenue Code long has been interpreted to permit the materially different aspect of the realization requirement.

Br. 26-29); three early tax decisions of this Court preclude the requirement (*id.* at 35-40); the statutory nonrecognition provisions of Sections 1031 and 1091 preclude the requirement (*id.* at 32-33); and the requirement would produce "an administrative nightmare" (*id.* at 42-43). None of these contentions is well founded.

Petitioner first seeks to rely on the provisions of Section 1001 and their legislative history. According to petitioner, Section 1001(a) is purely computational, and Section 1001(c) requires that the consequences of any sale or exchange be recognized unless another non-Section 1001 provision specifically provides for nonrecognition. Petitioner misconstrues these provisions.

As we have noted, the realization requirement is derived from an interpretation of Section 1001(a), taken together with related provisions in Section 61 and Section 165. That Section 1001(a) includes a realization requirement is well recognized. See, e.g., 2 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 40.2, at 40-4 (2d ed. 1990) (Section 1001(a) "implies that increases and decreases in the value of property are not taken into account for tax purposes when they accrue, but only when they are realized by a taxable event") [hereinafter Bittker & Lokken]. Indeed, initially, petitioner agrees that Section 1001(a) includes a realization requirement. See Pet. Br. 14 ("Even though Section 1001(a) is entitled 'Computation of Gain or Loss,' it is understood to include the realization requirement."). Petitioner then shifts ground and contends that Section 1001(a) is entirely computational and does not include a realization requirement. See Pet. Br. 27 ("Sections 1001(a) and (b) merely set forth the manner of computing the amount realized on a transaction, and do not create a statutory standard for realization.").

In contrast, the Commissioner's interpretation of Section 1001(a) is consistent and reasonable. As an initial

matter, we agree that Section 1001(a) does not itself state a test for realization; no provision of the Code sets forth a definition of what events are realization events.¹⁹ Nevertheless, although Section 1001(a) is entitled "Computation of Gain or Loss," its use of the term "amount realized" plainly indicates that there is a realization requirement. In arguing that Section 1001(a) is purely computational, petitioner relies on legislative history indicating that Section 1001(a) shows "the method of determining the amount of gain or loss from the sale or other disposition of property." H.R. Rep. No. 179, 68th Cong., 1st Sess. 12 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 13 (1924). The realization requirement, however, is necessarily part of the determination of the amount of taxpayer's gain or loss, because if there is no realization event there is *no* gain or loss. The Commissioner's longstanding interpretation of Section 1001(a)—that Section 1001(a) and related provisions reflect a realization requirement, and that as part of that requirement, in an exchange of property, the property must be materially different if the exchange is to be a realization event—is, at the very least, a reasonable construction and should be upheld.²⁰

¹⁹ The realization requirement existed as a judicial doctrine even before the enactment of Section 1001 and its predecessor. See *Helvering v. Horst*, 311 U.S. 112, 115 (1940) ("From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event.").

²⁰ We agree with petitioner (Pet. Br. 27) that the realization requirement is not found in Section 1001(b), which defines the "amount realized" from the "sale or other disposition of property" as "the sum of any money received plus the fair market value of the property (other than money) received." Section 1001(b) only comes into play *after* the realization requirement has been met; at that point, Section 1001(b) is used to determine the *amount* realized in the transaction. Nothing in Section 1001(b) precludes the interpretation of the realization requirement (and the corresponding materially different requirement) in Section 1001(a) and related provisions.

Petitioner also relies (Pet. Br. 28-29) on Section 1001(c) of the Code, but similarly misconstrues that provision. Petitioner maintains that Section 1001(c) provides that, except as otherwise provided in the Code, all gain or loss is recognized from all exchanges, and that "gains and losses that are recognized must necessarily be realized" (Pet. Br. 28). From these two premises, petitioner argues that Section 1001(c) requires realization of gain or loss on all exchanges, unless one of the Code's specific nonrecognition provisions applies.

Petitioner's first premise is erroneous. Section 1001(c) does not provide that all gains and losses are recognized; it provides, as we explain in our brief in *Centennial* (at 16-17), that all *realized* gains and losses—all gains and losses "determined under this section"—are recognized.²¹ See Treas. Reg. § 1.1002-1(a) ("The general rule with respect to gain or loss *realized* upon the sale or exchange of property as determined under section 1001 is that the entire amount of such gain or loss is recognized except in cases where specific provisions of Subtitle A of the Code provide otherwise.") (emphasis added);²² 2 Bittker & Lokken, *supra*, § 44.1.1, at 44-2 ("Under § 1001(c), gain or loss *realized* on a sale or exchange of property, as determined under § 1001(a), is 'recognized' unless a nonrecognition provision prescribes otherwise.") (emphasis added). Realization and recognition are thus separate steps in de-

²¹ Section 1001(c) provides:

Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

²² Petitioner's reliance (Pet. Br. 29, 42) on the Treasury Regulations under Section 1001(c), which provide that exceptions to the rule that realized gain or loss is recognized are "strictly construed" (Treas. Reg. § 1.1002-1(b)), is misplaced. The Regulation, like the statute, applies only to *realized* gains or losses. See Treas. Reg. § 1.1002-1(a).

termining the tax consequences of a transaction.²³ Once again, at a minimum, the Commissioner's interpretation of Section 1001(c) and its relationship to Section 1001(a), as embodied in the Treasury Regulations, is a reasonable construction and should be upheld. *Chevron, Inc.*, 467 U.S. at 843; *National Muffler Dealers Ass'n*, 440 U.S. at 477.

In an attempt to bolster its statutory argument, petitioner also seeks to rely (Pet. Br. 28) on the legislative history of the predecessor of Section 1001(c), Section 203(a) of the Revenue Act of 1924, ch. 234, 43 Stat. 256. Section 203(a) of the 1924 Act was enacted because Congress was dissatisfied with the provision of Section 202(c) of the Revenue Act of 1921, Tit. II ch. 136, 42 Stat. 230, which provided, in pertinent part, that "no gain or loss shall be recognized [on an exchange of property] unless the property received in exchange has a readily realizable market value." The Committee Reports on the 1924 Act stated that this provision "is so indefinite that it cannot be applied with any accuracy, nor with consistency." H.R. Rep. No. 179, *supra*, at 13; S. Rep. No. 398, *supra*, at 14. Accordingly, Congress provided instead, in Section 203(a) of the 1924 Act, that "[u]pon the sale or exchange of property the entire amount of the gain or loss, determined under section 202"—*i.e.*, the entire amount of *realized* gain or loss—"shall be recognized, except as hereinafter provided in this section." Nothing in Section 203(a) or its

²³ The statutory distinction between realization and recognition was, perhaps, easier to see in the 1954 version of the Code, in which the recognition rule of present-day Section 1001(c) stood alone in its own section of the Code, Section 1002. The provision of old Section 1002 became Section 1001(c) in 1976. Tax Reform Act of 1976, Pub. L. No. 94-455, Tit. XIX, § 1901(a)(121), 90 Stat. 1784. This amendment was not intended to have any substantive effect. See S. Rep. No. 938, 94th Cong., 2d Sess. 491, 550 (1976).

legislative history supports petitioner's argument that every exchange of property is a realization event. In stating that elimination of the "readily realizable market value" requirement would produce "definiteness and accuracy" in determining when gain or loss is recognized and in related comments (H.R. Rep. No. 179, *supra*, at 13; S. Rep. No. 398, *supra*, at 14), the Committee Reports are discussing recognition, not realization.²⁴

3. Petitioner argues that this Court's decisions in *Eisner v. Macomber*, 252 U.S. 189 (1920), *Weiss v. Stearn*, 265 U.S. 242 (1924), and *Marr v. United States*, 268 U.S. 536 (1925), support its position that the materially different requirement should be invalidated. Pet. Br. 35-40. The

²⁴ Contrary to petitioner's suggestion (Pet. Br. 30-35), moreover, nothing in the legislative history of the 1924 Act indicates that Congress was dissatisfied with the Treasury Department's view of the realization requirement, as then expressed in Treas. Reg. 45, Art. 1563 (1920 ed). As we have noted (note 13, *supra*), prior to the enactment of the Revenue Act of 1924, that Regulation provided a realization requirement for an exchange—gain or loss was realized from the disposition of property when the property was "converted into cash," or converted into property "that [was] essentially different from the property disposed of * * * In other words * * * a change in substance and not merely form * * * [was] required to complete or close a transaction from which income may be realized." Accord, Treas. Reg. 62, Art. 1564 (1921 Revenue Act). Far from repudiating the Treasury Regulation, Congress intended Section 202(a) of the 1924 Act to "embod[y] in the law the present construction by the [Treasury] department * * * of the existing law" (H.R. Rep. No. 179, *supra*, at 12; S. Rep. No. 398, *supra*, at 13), and the enactment of Sections 202(a) and 203(a) of the 1924 Act clearly does not evidence congressional rejection of the Regulation's "essentially different" requirement.

Petitioner also incorrectly implies (Pet. Br. 31) that the legislative history of the earlier 1921 Act suggests that Congress was dissatisfied with the "essentially different" standard. The Senate Report cited by petitioner says nothing about the essentially different standard, and, therefore, does not evidence congressional disapproval. S. Rep. No. 275, 67th Cong., 1st Sess. 11-12 (1921).

Fifth Circuit correctly rejected a similar argument in *San Antonio Sav. Ass'n v. Commissioner*, 887 F.2d 577, 583-585 (1989), petition for cert. pending, No. 89-1928. The Fifth Circuit concluded that, in contrast to petitioner's position, these cases fully support the proposition that "the receipt of something materially different ('a thing really different') from that which the taxpayer had previously is necessary for an exchange to be considered a realization event." *Id.* at 583 (quoting *Weiss*, 265 U.S. at 254).

In *Eisner v. Macomber*, the Court held that a pro-rata dividend of common stock to the holders of common stock was not "income" to the shareholders within the meaning of the Sixteenth Amendment. The Court reasoned that there was no basic change in the position of the corporation and its shareholders; the stock dividend "does not alter the preexisting proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of the shares, with consequent dilution of the value of each share." 252 U.S. at 211. A stock dividend is not a "realization of profits of the stockholder." *Ibid.* Rather, "the corporation is no poorer and the stockholder is no richer than they were before." *Id.* at 203 (quoting *Towne v. Eisner*, 245 U.S. 419, 426 (1918)). Petitioner correctly observes that *Eisner v. Macomber* established that a mere increase or decrease in the value of property does not constitute gain or loss, and that some event is required for realization of gain or loss. Pet. Br. 35-37. But *Eisner* provides no support for petitioner's corollary that "[g]ain or loss, if any, is realized on an asset at the point at which the taxpayer relinquishes all dominion and control of his asset." *Id.* at 37. Indeed, subsequent decisions of this Court concerning stock dividends held that such dividends

may be taxed—not pursuant to petitioner's "dominion-and-control" formula—but based on whether the stock dividend left the recipient in an "essentially different" economic position with respect to his stock after the dividend.²⁵

In *Weiss*, the Court applied the principles of *Eisner v. Macomber* to an exchange. In *Weiss*, a corporation was liquidated, its assets were transferred to a new corporation, and the old stockholders received half of the stock in the new corporation as well as cash circuitously transferred by new investors. In effect, a stockholder sold half his stock for cash, and received stock in the new corporation in exchange for the other half of his stock in the old corporation. The Court held that no gain was realized on the exchange of the stock because there was merely a "change for purposes of reorganization in the technical ownership of an enterprise * * * followed by issuance of new certificates." 265 U.S. at 254. "Something more is necessary" for realization, the Court observed, "something which gives the stockholder a thing really different from what he theretofore had." *Ibid.* The Court's reference to "a thing really different" certainly is consistent with the conclusion that, for an exchange to constitute a realization event, the taxpayer must receive property that is materially different from the property he gave up.

In *Marr*, a new corporation was organized in a different State to take over the assets and assume the liabilities of an old corporation. The Court held that a taxpayer who received stock in the new corporation in exchange for his stock in the old corporation realized a gain on the exchange. The Court concluded that "the new corporation

²⁵ See, e.g., *Helvering v. Sproule*, 318 U.S. 604, 607-608 (1943); *Koshland v. Helvering*, 298 U.S. 441, 445-446 (1936). See generally, B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 7.41 (5th ed. 1987).

[was] essentially different from the old," because a corporation organized in one State did not have the same rights and powers as a corporation organized in another State. 268 U.S. at 541. The Court also examined the characteristics of the stock itself, concluding that six percent nonvoting preferred stock was "essentially different" from seven percent voting preferred stock, and that the old and new common stock were "essentially different" because they were subject to different amounts of preferred stock priorities and to different amounts of annual dividends on the preferred stock. *Ibid.*²⁶ Thus, in *Marr*, the Court carefully examined the character and significance of the differences in the exchanged property in determining whether a realization event had occurred.

In sum, this Court in *Weiss* focused on whether the taxpayer received something "really different" (265 U.S. at 254) and in *Marr* focused on whether the taxpayer received something "essentially different" (268 U.S. at 541). The requirement that property exchanged must be materially different for gain or loss to be realized is completely consistent with the Court's focus in those cases. See *Emery v. Commissioner*, 166 F.2d 27, 29 & n.6 (2d Cir. 1948) (equating the Treasury Regulation's "materially different" requirement with the *Weiss* test that the exchange must give the taxpayer "something * * * really different from what he theretofore had").²⁷

²⁶ The Court distinguished *Weiss* on the ground that, in *Weiss*, the old and new corporations were organized in the same State and there was no change in the character of the stock. 268 U.S. at 541. See also *id.* at 540 (agreeing with the government that, "in the case at bar, the gain actually made [was] represented by securities with essentially different characteristics in an essentially different corporation").

²⁷ In *Emery*, the court held that the taxpayer realized a gain on the exchange of municipal bonds for new bonds of the same issuer because "the new bonds did differ materially from the old." 166 F.2d at 29.

Petitioner, however, contends that *Weiss* and *Marr* preclude the application of a materially different requirement to exchanges of different property. Pet. Br. 38-40. Petitioner acknowledges that *Weiss* and *Marr* establish and reflect a "materially different" requirement for realization in certain situations. See *id.* at 38. But, according to petitioner, this requirement is limited to a situation in which a taxpayer exchanges an *interest* in property for an *interest* in the same property, rather than when the taxpayer exchanges property for different property. See *ibid.* ("The cases conclude that a taxpayer may realize gain or loss with respect to property *without disposing of his interest in the property*, if he receives an interest in the property that is 'essentially' or 'materially' different from his original interest in the same property.") Thus, in petitioner's view, *Weiss* and *Marr* hold only that, where a taxpayer exchanges his interest in property for a different (but not materially different) interest in the same property, no realization event has occurred. Petitioner offers no sound reason, however, for its assertion that a different rule should apply when a taxpayer exchanges property for different (but not materially different) property. In either situation, the taxpayer winds up with something not materially different from what he had before, and the same reasons for finding non-realization should govern.

4. Petitioner also contends that the "materially different" requirement for realization is inconsistent with the nonrecognition provisions of Sections 1031 and 1091 of

Petitioner's assertion that "[t]he new bonds were convertible into registered form, but were identical in all other respects" (Pet. Br. 40) is incorrect. The Second Circuit observed that "[t]he interest rate of the new bonds was substantially less after the call dates of the old bonds; the new bonds matured from one to 23 years earlier than the old bonds; and the period during which the city optionally might call in the bonds was shortened." 166 F.2d at 29.

the Code. Pet. Br. 32-33, 41-42. This contention is mistaken. Section 1031 generally provides that no gain or loss is recognized on the exchange of certain kinds of property for "property of a like kind." Section 1031(a). Section 1091 generally disallows losses from "wash sales" of stock or securities—situations in which the taxpayer acquires "substantially identical stock or securities" within 30 days of the sale. Section 1091(a).

Petitioner's argument assumes that the Commissioner's "materially different" requirement would bar realization in each of the situations covered by Sections 1031 and 1091, rendering those nonrecognition provisions superfluous. That assumption is wrong. Section 1031 deals with exchanges of "like kind" property, a much broader concept than property that is not materially different. "Like kind" refers to general classes of property, such as real property. See generally *Commissioner v. Crichton*, 122 F.2d 181, 182 (5th Cir. 1941); Treas. Reg. § 1.1031(a)-1(b) and (c). Accordingly, an exchange in which gain or loss is *realized* because the property is materially different (e.g., two parcels of real property) may nonetheless, because the property is of like kind, result in no *recognition* of gain or loss under Section 1031. Indeed, an exchange of urban commercial real estate for a farm (Treas. Reg. § 1.1031(a)-1(c)) or of an outfielder for a third baseman (see Rev. Rul. 67-380, 1967-2 C.B. 291) would qualify as a like kind exchange under Section 1031, but obviously would involve property that is materially different.

Section 1091 concerns sales and purchases of certain property—substantially identical stock or securities—that take place within thirty days of each other. Section 1091 disallows any loss incurred on such a "wash sale." Section 1091 applies regardless of whether the transaction is properly characterized as an exchange, subject to the materially

different requirement for realization. See *Shoenberg v. Commissioner*, 77 F.2d 446, 450 (8th Cir.) (predecessor of Section 1091 avoids need for inquiry into whether sale and repurchase were part of a plan), cert. denied, 296 U.S. 586 (1935).²⁸ Thus, the "materially different" requirement for realization in the context of property exchanges renders neither Section 1031 nor Section 1091 superfluous.

Petitioner also relies on Sections 1031 and 1091 for something of an *expressio unius, exclusio alterius* argument. Neither of the nonrecognition provisions applies to mortgage exchanges. See Pet. Br. 23, 32, 41-42. According to petitioner, that suggests that loss from such exchanges must be realized. Not so. Petitioner's argument confuses recognition and realization.

The materially different requirement is a minimum, threshold requirement that must be satisfied in order for an exchange of property to be a realization event. Sections 1031 and 1091 come into play after (or assuming *arguendo* that) this threshold requirement is met. Accordingly, the fact that Sections 1031 and 1091 do not apply to many debt obligations in no way indicates that gain or loss is realized on the exchange of debt obligations (or other types of property) that are not materially different.²⁹

²⁸ Transactions subject to Section 1091 typically do not involve an exchange of stock between buyer and seller, but rather open market sales followed by open market purchases.

²⁹ Petitioner also relies on the legislative history of Section 1031. Pet. Br. 33. A House Report discussing the exclusion of notes and securities from the nonrecognition rules states that, under Section 1031, gain or loss is "recognized in the case of exchanges of notes or securities." H.R. Rep. No. 704, 73d Cong., 2d Sess. 13 (1934). The Report discusses only recognition. Nothing in the Report states that gain or loss is realized on *all* exchanges of notes or securities. Moreover, the case law (discussed in our *Centennial* brief, at 14) holds otherwise. See *Mutual Loan & Savings Co. v. Commissioner*, 184

Sections 1031 and 1091 do not create some automatic rule of realization for any transaction that is not within their terms for nonrecognition.³⁰ Indeed, courts have long held that sales and purchases of substantially identical securities will not necessarily result in *realization* of gain or loss, even if they are not within the scope of Section 1091 (or its predecessor).³¹ This analysis is simply an ap-

F.2d 161 (5th Cir. 1950) (exchange of municipal bonds was not a taxable exchange); *City Bank Farmers Trust Co. v. Hoey*, 52 F. Supp. 665 (S.D.N.Y. 1942) (same), aff'd, 138 F.2d 1023 (2d Cir. 1943); *West Missouri Power Co. v. Commissioner*, 18 T.C. 105 (1952) (same).

³⁰ The difference in scope between Section 1091 and the materially different requirement is readily apparent. Section 1091 deals only with the disallowance of losses from wash sales of stock or securities. The materially different requirement of Treas. Reg. § 1.1001-1(a), in contrast, applies both to gains and losses, and is not limited to any particular type of property. And, as we have explained in text (p. 25, *supra*), Section 1031 obviously differs in scope from the materially different requirement.

³¹ See, e.g., *Shoenberg v. Commissioner*, 77 F.2d 446, 449-450 (8th Cir.), cert. denied, 296 U.S. 586 (1935); *Horne v. Commissioner*, 5 T.C. 250 (1945). See also *Smith v. Commissioner*, 78 T.C. 350, 388-389 (1982) (acknowledging wash sale approach outside the scope of Section 1091, but finding that particular transaction was not covered by it); 2 Bittker & Lokken, *supra*, § 44.7.6, at 44-107 (wash sale can be disregarded when the transaction "lacks economic substance").

Petitioner argues that *Shoenberg* is inapposite because it involved a sale and reacquisition of identical property, i.e., corporate stock. Although the instant case involves a sale and reacquisition of "substantially identical" property, the *Shoenberg* court's reasoning, by its explicit terms, is equally applicable here. Where a sale of property "is made as part of a plan whereby substantially identical property is to be reacquired," the loss "is not real" because "the taxpayer has not actually changed his position." 77 F.2d at 449.

Petitioner also suggests that *Horne* is inapposite because, according

plication of the realization requirement. Where a taxpayer disposes of property in a transaction in which he receives property that is not materially different from the property he gave up, he realizes no gain or loss.³²

5. Petitioner also maintains that the "materially different" standard should be rejected because it would produce an "administrative nightmare." Pet. 42-43. Petitioner's contention is flawed for several reasons. First, petitioner forgets that *it* is the party urging a change in the law and an invalidation of the requirement that has been in the Treasury Regulations for 55 years. Indeed, as we have noted (*supra*, pages 11-13), the requirement has been long recognized by courts and commentators (and by the Bank Board as the very reason for the R-49 transactions). This long established requirement has not produced administrative difficulties or taxpayer confusion in the past, and

to petitioner, *Horne* was decided under the "like kind" exchange rule of Section 1031. Pet. Br. 21 n.15. Petitioner is incorrect. The *Horne* decision cited the like kind provision by analogy. See 5 T.C. at 285-286. See also *Smith*, 78 T.C. at 388 (citing *Horne* as an example of "nonstatutory wash sale consequences").

³² Petitioner also seeks to rely on Section 56(g)(4)(E) of the Code (26 U.S.C.), which now provides that, in determining "adjusted current earnings" for purposes of the alternative minimum tax on corporations, "[n]o loss shall be recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities." As with Section 1031, however, this Section has a much wider scope than the materially different requirement, and it applies to exchanges even if they satisfy the materially different requirement. Petitioner's suggestion that the statutory provision and the R-49 criteria are coextensive is mistaken. As Memorandum R-49 recognizes, debt obligations have many characteristics besides interest rates and maturities. See Pet. App. 59a-60a. Indeed, interest rates and maturities are only two of the ten characteristics that must be common to two or more mortgage loans before the loans may be considered "substantially identical" under the Bank Board's Memorandum R-49. *Ibid.*

there is no reason to think that it would in the future. As we show in our *Centennial* brief (at 17-18), moreover, the principle of materiality is hardly a novel concept in the law.

Second, petitioner is incorrect in stating that upholding the materially different requirement will usher in a new era of tax shelters. As an initial matter, petitioner's professed concern for eliminating opportunities for tax avoidance needs to be taken *cum grano salis*, given that petitioner—according to the factual findings of the Tax Court (Pet. App. 31a, 35a & n.9)—entered into these transactions "solely" for the purpose of tax avoidance. Petitioner's argument is, in any event, untenable. The specter of taxpayers with appreciated property shielding their gains by exchanging the property for substantially identical property (when they need only keep their existing property to avoid tax consequences) is fanciful.³³

Third, and of particular importance, Congress charged the Commissioner, not petitioner, with making appropriate judgments about administrability. The question is whether the materially different requirement is a permissible interpretation of the Internal Revenue Code, not whether petitioner would exercise administrative discretion in a different fashion. The Commissioner's longstanding position that, in order for an exchange of property to be a realization event, the property exchanged must be materially different, is reasonable and sound, and should be upheld.

³³ This is not to deny that, as some of the early materially different cases reveal, there may be circumstances in which it is advantageous for a taxpayer to attempt to claim that property in an exchange was not materially different. It is to say, however, that petitioner's professed fears of a massive tax shelter are greatly exaggerated. Indeed, to the extent that the Commissioner's materially different rule may, in some circumstances, operate to the benefit of taxpayer, it illustrates only that the rule is even-handed and founded on a neutral principle.

B. The Mortgage Loans Exchanged By Petitioner Were Not Materially Different

We explain in our brief in *Centennial* (at 17-18) that a material difference is a difference that has the capacity to affect a decision. We then demonstrate (*id.* at 18-26) that the available evidence from (1) the conduct and intent of the parties, (2) the evaluation of the pertinent market (the secondary mortgage market), and (3) the determination of the agency charged with regulating federal savings and loan associations (the Bank Board), confirms that the differences in the mortgage pools exchanged in *Centennial* were not material. Consideration of these factors leads to the same conclusion in this case. The latter two factors—the evaluation of the market and the determination of the Bank Board—are the same in this case as in *Centennial*, and there is no need to restate the discussion from our *Centennial* brief (at 21-26).¹⁴

As in *Centennial*, the conduct and intent of the parties in this case also establish that the differences in the swapped mortgage pools were not material. Petitioner and its trading partners did not investigate the credit ratings of any of the borrowers on the loans they received and did not investigate the value of the real estate that secured the loans. Pet. App. 4a, 28a. Petitioner made no attempt to determine, on a loan-by-loan basis or an aggregate basis, whether there was a difference between the prepayment potential or anticipated income stream of the loans it re-

¹⁴ Although the Tax Court in this case did not make explicit factual findings concerning the evaluation of the secondary mortgage market, the finding in *Centennial* was generally applicable to the R-49 transactions. See Pet. App. 52a, No. 89-1926 (“[B]ecause information was not available at the time of the transaction regarding individual differences among the loans, the marketplace was unable to and did not differentiate between the pools.”). See also Pet. Br. 14 n.5 (noting that the facts of this case are “similar” to the facts of *Centennial*).

ceived and the loans it transferred. *Id.* at 29a. Petitioner and its trading partners drew no distinctions among individuals loans in valuing them. They applied a common discount factor in pricing all of the loans, thereby indicating that they could discern no difference in the overall risk of the loans involved in the exchanges. *Id.* at 3a, 25a. As in *Centennial*, it is thus clear that, with regard to the conduct and intent of the parties, the differences in the mortgage loan pools were not material; the differences did not make a difference.¹⁵

Petitioner urges that the available evidence from these sources be rejected. With regard to the conduct and intent of the parties, petitioner claims that “objective factors,” rather than its “personal views,” should be relevant. Pet. Br. 46. As we explain in *Centennial* (at 21), the conduct and intent of the parties, as economic actors, are probative of the objective nature of the transaction, including the materiality of claimed differences, and are an appropriate consideration in the overall evaluation of materiality.

With regard to the evaluation of the market, petitioner contends that it would not be feasible to consider this evidence. Pet. Br. 45-46. As we point out in *Centennial* (at 22), however, courts have long considered the market perspective in analyzing the significance of differences in exchanged properties, and a blanket exclusion of this probative evidence is unwarranted. Petitioner also suggests that

¹⁵ In a triumph of understatement, petitioner acknowledges (Br. 46) that “[i]t is true that [petitioner] may not have been overly concerned with individual differences in the mortgages it exchanged in the R-49 transaction.” Cf. Pet. App. 35a-36a n.9 (“[T]he generation of the tax loss deduction was the sole motive for the transactions in dispute.”); *id.* at 31a (“The December 31, 1980, transactions were motivated solely by the desire of petitioner and its trading partners to recognize for tax purposes (but not for regulatory purposes) the losses in market values of the loan portfolios each institution owned before the December 31, 1980, transactions.”).

the evaluation of the pertinent market should be irrelevant because "[a]ny transaction involving similar assets would be perceived by the marketplace as equivalent." Pet. Br. 46 n.43. As we explain in *Centennial* (at 23 and n.19), there is a fundamental difference between the concept of equivalent value and the concept of material difference, and the evaluation of the secondary market can be quite helpful in considering whether differences are material even if the market (and the parties) assign the properties equivalent value. The point is not simply that the market assigned the same value to the properties exchanged, but rather that the market did not consider the differences now relied on by petitioner to be at all pertinent in arriving at that same value.³⁶

Finally, in its application of the materially different requirement (Pet. Br. 43-50), petitioner essentially ignores the fact that the Bank Board determined that mortgage loans were "substantially identical" if they met the R-49 criteria (Pet. App. 59a).³⁷ As we explain in our *Centennial*

³⁶ For example, stock certificates of a company typically differ in that each bears a distinctive serial number. The market, however, views certificates of the same class as being of equal value—the difference in serial numbers is not a *material* difference affecting value; it is not a difference the market considers in arriving at value. The market may also happen to value shares of ABC corporation and shares of XYZ corporation at the same price, but this does not mean that the shares are not materially different. Because ABC and XYZ differ in various respects—which the market considers and weighs in arriving at value—the shares are materially different. Here the differences in borrowers and collateral on which petitioner now relies were not differences that the market considered and weighed-in concluding that the pools of mortgages had the same value.

³⁷ Petitioner discusses the role of the Bank Board in its Section 165 analysis (Pet. Br. 16-19), and contends that the R-49 focus on ensuring substantial identity of risk is irrelevant; as we show in our *Centennial* brief (at 18-19) and as the Bank Board itself emphasized (Pet. App. 21a-22a), assessment of risk is the core of the secondary mortgage market.

brief (at 23-26), the Bank Board's expert conclusion concerning the significance of differences between packages of mortgage loans is clearly pertinent to consideration of those differences.

Rejecting the relevance of the evidence from the evaluations of the Bank Board, the pertinent market, and the conduct and intent of the parties, petitioner maintains that the pools of loans were nonetheless materially different because (1) the individual loans concern different borrowers, (2) the individual loans are secured by different collateral, (3) each swap was for 90% participation interests, and (4) the loan pools eventually had different performances. Pet. Br. 47. With regard to the first two factors, as we pointed out in our *Centennial* brief (at 26), an across-the-board rule that differences in borrowers and collateral are always material is far too sweeping and fails to take into account differences in contexts and transactions. With regard to the 90% participation interest, such an exchange was a common form of R-49 transaction (see Gov't Br. (*Centennial*) at 4), and that form of the exchange did not itself create material differences in the exchanged mortgage loan pools; indeed, petitioner overlooks the fact that the *exchange* was an exchange of 90% participation interests (Pet. App. 3a-4a, 24a-26a), and thus there was no difference at all in the exchanged loan pools concerning participation interests. With regard to the eventual performance, as we explain in *Centennial* (at 27-28), the question whether the mortgage loans were materially different turns on the significance of whatever differences were known at the time of the exchange, not on a *post hoc* evaluation of subsequent performance.³⁸

³⁸ Petitioner maintains that the decision in *Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939), supports its position. Pet. Br. 47-50. As we explain in *Centennial* (at 27 n.22), this contention is erroneous.

In sum, petitioner seeks to exclude the available evidence from the conduct and intent of the parties, the evidence of the pertinent market, and the expert judgment of the administrative agency charged with overseeing the field. Petitioner seeks instead to substitute a list of factors that made no difference at the time – and, in the particular context, did not have the capacity to make a difference – to the parties, the market, or the agency. Petitioner's approach would strip the concept of materiality of any meaningful content and would accomplish, through application of the materially different requirement, what petitioner also seeks in its direct assault on that requirement – effective elimination, in practical terms, of the requirement itself. Petitioner's attempt should be rejected, and the Commissioner's determination that these exchanges of substantially identical mortgage pools fail to reveal material differences in the exchanged property should be upheld.¹⁹

¹⁹ Although the court of appeals held that there is no "materially different" requirement for realization in an exchange of property, the court went on to hold that the deduction of the "loss" was not allowable under Section 165 of the Code. Pet. App. 10a-15a. Applying the principle that purported losses from transactions lacking economic substance are not deductible under Section 165 (see Gov't Br. (*Centennial*) at 16 n.11), the court held that the R-49 exchange did not give rise to a loss deductible under Section 165 because petitioner's "economic position was not changed" by an exchange of a pool of mortgages for a "substantially identical pool of mortgages." Pet. App. 14a. For the reasons we have discussed, the court of appeals' conclusion that there is no materially different requirement under Section 1001(a) is incorrect. As we also note in our *Centennial* brief (at 16 n.11), however, Section 165 and Section 1001(a) are related in that there would be no purpose for Section 1001(a) to provide rules for determining the amount of a loss if Section 165 did not allow a deduction for that loss. Thus, the principle that purported losses from transactions that lack economic substance are not deductible under Section 165 (see Treas. Reg. § 1.165-1(b)) can be viewed as simply another way of saying that

CONCLUSION

The judgment of the court of appeals should be affirmed.

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no loss is "realized" on such transactions. Accordingly, the same considerations that led the court of appeals to conclude that in substance petitioner had not sustained a loss within the meaning of Section 165 should have led it to conclude that petitioner had realized no loss under Section 1001(a) in the first instance.

To the extent that the court of appeals' premise that there is no materially different requirement is accepted (which would, we believe, be a serious misinterpretation of the Code), we agree that the deductions nevertheless should be disallowed because the transactions lacked economic substance and thus did not produce losses deductible under Section 165. See Gov't Br. (*Centennial*) at 17 n.12.

* The Solicitor General is disqualified in this case.

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No. 89-1965

In The
Supreme Court of the United States
October Term, 1990

COTTAGE SAVINGS ASSOCIATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

v

On Writ Of Certiorari To
The United States Court Of Appeals
For The Sixth Circuit

REPLY BRIEF

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REPLY ARGUMENT

I. THE GOVERNMENT HAS VIRTUALLY ABANDONED ITS SECTION 165 ARGUMENT.

The Government has virtually abandoned the Sixth Circuit's conclusion that Section 165 of the Code (Petitioner's Brief at 13-26) prevents deduction of Cottage Savings Association's loss on the transaction at issue by relegating its position to a mere footnote. Respondent's Brief at 34, n. 39. Apart from its mistaken reliance on Section 165 to deny Cottage's loss, the Sixth Circuit agreed with the decisions of the Fifth Circuit in *Centennial*, *First Federal of Temple* and *San Antonio*¹ and the D.C. Circuit in *Federal National Mortgage Association*² that losses from the exchange of mortgage loans for completely different mortgage loans should be realized as well as recognized under the tax law. Thus, no real conflict exists among the circuit courts with respect to the issue of realization of losses which is before the Court in this case and in *Centennial* (to be argued in tandem with this case) and the other cases for which certiorari is pending.

II. THE MORTGAGE LOANS THAT PETITIONER EXCHANGED WERE MATERIALLY DIFFERENT.

A. Even if a materially different standard does apply, which we dispute (Petitioner's Brief at 26-43), then that standard has been met by Cottage Savings Association. The controlling decisions of this Court establish that

¹ *Centennial Sav. Bank FSB v. United States*, 887 F.2d 595 (5th Cir. 1989), cert. granted, 59 U.S.L.W. 3243 (U.S. Oct. 1, 1990) (No. 89-1926); *First Fed. Savs. & Loan Ass'n of Temple v. United States*, 887 F.2d 593 (5th Cir. 1989), petition for cert. pending, No. 89-1927; and *San Antonio Savs. Ass'n v. Commissioner*, 887 F.2d 577 (5th Cir. 1989), petition for cert. pending, No. 89-1928.

² *Federal National Mortgage Ass'n v. Commissioner*, 896 F.2d 580 (D.C. Cir. 1990), petition for cert. pending, No. 89-1987.

whether or not exchanged assets are materially different is determined by reference to objective factors. In *United States v. Phellis*, 257 U.S. 156, 173 (1921), the Court held that shareholders realized gain when the DuPont Company reorganized from a New Jersey to a Delaware corporation, because the exchanged stock had "property rights and interests [that were] materially different."³ Likewise, in *Marr v. United States*, 268 U.S. 536, 541 (1925), the Court held that, because of "differences in rights and powers" between exchanged shares, General Motors' stockholders realized gain upon the company's reincorporation in a different state. Thus, this Court has adopted a narrow and objective standard, under which realization fails to occur only if the taxpayer holds the same property rights and interests before and after the exchange.

In contrast, the Government would have the determination of whether realization occurs depend upon a subjective analysis of the parties' conduct and intent, and on an economic evaluation of the relevant marketplace. This Court, however, has never inquired into these subjective factors in resolving the issue of realization and the Government cites no cases in this regard. To the contrary, the Court's opinions establish that such factors are irrelevant. In *Phellis*, the Court concluded that the "design and purpose of the participants" were of no consequence and, further, that a comparison of the values assigned by the marketplace to the exchanged stock was a "circumstance of no particular importance." 257 U.S. at 170, 172. In *Marr*, the Court observed that in *Phellis*, *Rockefeller*, *Cullinan*, and *Marr* "the business enterprise actually conducted remained exactly the same." 268 U.S. at 540. Thus, in these cases, the parties did not intend to exchange stock that was economically different and, to the marketplace,

³ The Court followed *Phellis* in *Rockefeller v. United States*, 257 U.S. 176 (1921), and *Cullinan v. Walker*, 262 U.S. 134 (1923), again holding that gain was realized upon exchanges of stock.

the stock exchanged had identical potential future performance. Yet, notwithstanding these considerations, the Court held in each of the cases that a realization event had occurred.

Application of Respondent's subjective test would result in the determination that realization did not occur in *Phellis*, *Rockefeller*, *Cullinan*, and *Marr*. Accordingly, if the Court were to adopt Respondent's test, it would have to reject both the reasoning applied and the result reached in its seminal realization cases.

B. If, as the Government suggests, the Court abandons its objective, brightline test for a subjective approach, the result would be to infuse an area of the tax law now well-settled with controversy, uncertainty and inconsistency.

Under a subjective approach, every determination of whether a realization has occurred henceforth would require a detailed inquiry into the conduct and intent of the parties, as well as a complete economic analysis of the relevant marketplace. Under such a test, factual controversies would proliferate, creating uncertainty and greatly complicating tax administration. For example, if the Court were to decide this case by applying a subjective test, its decision would not resolve the tax treatment of any other R-49 transaction. Rather, the tax treatment of each R-49 transaction would need to be determined based upon a detailed examination of the particular exchange. Indeed, under a subjective realization test, case-by-case determination would be required not only in all other R-49 transactions, but in all varieties of exchanges and dispositions.

Adoption of a subjective realization test would also likely result in inconsistent treatment of similarly situated taxpayers. Exchange transactions that were objectively identical could be treated differently depending upon conclusions regarding the conduct and intent of the parties to the transactions. Moreover, parties to the very same transaction (including the same R-49 transaction)

could be treated differently depending upon their individual actual or alleged intentions. That such uncertainty and inconsistency would result from so fundamental a question as the realization of gain or loss illustrates the unsuitability of the Government's subjective test.

C. In this case, objective factors demonstrate a material difference between the exchanged mortgages. The fact that the mortgages exchanged had different obligors and were secured by different underlying properties establishes as a matter of law that the mortgages were materially different. Additional inquiry into the record confirms that the exchanged mortgages had different delinquency, default and prepayment characteristics, and that they actually performed differently in these respects. See Petitioner's Brief at 7. These differences are highlighted by the fact that the exchanged mortgages varied by geographic location. Petitioner's Brief at 7. Given these and many other objective differences between the mortgages exchanged, there can be no doubt that Cottage held different property rights before and after the transaction and that the exchanges in question here are properly considered realization events.

D. As mentioned above, the Government relies heavily on subjective factors including the conduct and intent of the parties to demonstrate that the differences in the mortgage loans were not material. The Respondent's Brief at 28-32, *Centennial* (No. 89-1926), the Amicus Curiae Brief of the United States League of Savings Institutions at 17-20, *Centennial* (No. 89-1926) and the Amicus Curiae Brief of the Federal National Mortgage Association at 19-24, *Centennial* (No. 89-1926) all point out the fallacy in the Government's arguments with respect to material difference and need not be restated here.

E. Finally, the government's argument that Cottage did not realize a loss on the exchange of mortgage loans hinges on the definition of "material" in the phrase "materially different" since it is clear that Cottage exchanged completely "different" mortgage loans in the

transaction at issue. Respondent's Brief at 18, n. 15, *Centennial* (No. 89-1926). As pointed out in Respondent's Brief at 29, *Centennial* (No. 89-1926), the Government relies on dictionaries rather than the law for its definition of "material difference." The Fifth Circuit in *San Antonio, Centennial* and *First Federal of Temple* and the D.C. Circuit in *Federal National Mortgage Association* properly applied an objective test for material difference.

For the reasons set forth in this Reply Brief and in the Brief for Petitioner previously filed, the decision of the Court of Appeals for the Sixth Circuit should be reversed.

Respectfully submitted,

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